A collection of interviews with financial markets experts on investing, superannuation, retirement and other topical issues, as published by Firstlinks over 2021 and 2022

Firstlinks Interview Series 2021-22

With Graham Hand

Firstlinks
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Introduction

Graham Hand

One of my favourite parts of curating Firstlinks is learning more about products and businesses in our Interview Series.

The interviews go beyond the usual marketing messages to identify investments and ideas from leaders in the asset management industry and financial services generally. We often allow the interviewee to mention their own products as readers need to know where to find out more. This latest collection of 23 experts covers most asset types and is a window into how portfolios can become more diversified to manage risk.

From the start of Firstlinks in 2012, we have focussed on the insights of market experts into investing, superannuation and many social and demographic issues. Our audience now totals about 100,000 Monthly Active Users making over two million pageviews a year. Morningstar's acquisition of Firstlinks has provided additional resources and distribution reach.

The Firstlinks website includes a searchable archive with thousands of articles and is worth a visit to learn more about a vast range of investing topics.

These interviews have not been 're-edited' and should be read in the context of the date they were written. They are general information and do not consider the circumstances of any investor.

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Graham Hand, Editor-At-Large, Firstlinks

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Andrew Swan, Man GLG: The right way to invest in a thematic is not an index

7 September 2022

Investing in Asia is challenging but with younger populations, many countries face less wage and inflation pressures than the West. Buying the index rarely pays off as it's more about finding the winning companies.

Andrew Swan is Head of Asia (ex-Japan) for Man GLG, the discretionary investment business of Man Group, a global manager of $200 billion in assets with headquarters in London. Andrew is based in Australia and joined Man in 2020 after starting his analyst career in 1994.

GH: You manage portfolios of Asian equities excluding Japan. How much of the performance and potential is a China story?

AS: Asia is an ever-changing part of the world. A few years ago, China was the dominant source of returns in the region, but China is going through a challenging transition that is a tough environment for equities. At the same time, we are seeing improving opportunities in the rest of the region, especially in Southeast Asia and India. Asia is really diverse and some smaller economies are improving a lot.

GH: What are say, three other countries with good medium-term potential?

AS: Indonesia, Thailand, Philippines have good opportunities, and a fourth, India, should be in the mix. Young populations in a fast-growing part of the world. Of course, that doesn’t always translate into good returns but the potential is strong at the moment.

GH: What about the global macro threats of inflation, interest rate rises and shortages in both labour and materials?

AS: Well, they are big challenges facing the rest of the world right now but one of the key reasons inflation is a problem in the West is the scarcity of labour. But these four countries offer young populations and an abundance of labour and they're not seeing wage inflation or interest rate pressure. These economies are more resilient to a global slowdown than in the past because they're more about domestic demand, and there's not the same level of speculation in the system as in the West. As a result, they're recovering strongly.

GH: Although Asian GDP grows faster than the rest of the world, you’ve written that Asian countries have arrived but Asian equities haven't. So now you’re seeing a brighter outlook?

AS: The greatest mistake people make when investing in Asia is to think that because it's a high growth market, it should generate higher returns for its companies. But that has not proven to be the case over the last decade. There have been some fantastic opportunities inside the market but the overall market has underperformed developed markets which have been growing at a slower pace. Overall, in Asia, there has been too much capacity and companies lose pricing power and profitability suffers.

But at a time when developed markets are slowing due to inflation and rising rates, we expect the narrative of the underperformance of Asian equities to come to an end. And with enormous dispersion inside the market, the opportunity set as a stock picker, as an active investor, is much better in Asia than in developed markets where stocks are more highly correlated. It's really tough to get returns above the market in developed markets.

GH: Most people in Australia are underinvested in Asia, and probably think they can gain Asian exposure through global large caps. I'm not only thinking of the big tech companies, but Procter & Gamble, Coca-Cola, Lever & Kitchen, Starbucks, they all have large Asian businesses. What does an Asian portfolio give to an Australian investor?

AS: Asian companies are exposed to different factors than in an Australian portfolio, and while large global companies give some Asian exposure, and they tend to be well managed, Asia is usually a small part of what they do. The last 10 years have been a developed market story but the West is now paying the price for an incredibly accommodative monetary environment but Asia does not have the same excesses in the system.

GH: Are geopolitical tensions in places such as Taiwan and Pacific islands making conversations with Australian investors more difficult?

AS: I have been doing this in Asia for 20 years, and it's always a question from investors. Not to be dismissive of it in any way, but in the last four months, it’s become more of a barrier. My response is in two parts. First, if a major military conflict happens, it will affect everything in your portfolio, Russia and Ukraine multiplied many times over with a big shock to the global supply chains. Mainland China and Taiwan are critical in global trade in all products from high tech like semiconductors through to low tech like base

materials. So this shock to the supply chain would hit all markets.

But the second thing is, following events of the last year or two, companies are rethinking how they do business in the region. After a couple of decades of globalisation and integration, we’re seeing an unwind. Rather than a first focus on the economics of a transaction, now geopolitics is probably equally first. Companies are adjusting their long-term thinking but they still want to be in places like China. It's a big, growing market. So they are reducing the number of logistical steps in their production and targeting more at the local Chinese market with local product. Multinationals in China are sourcing more locally than internationally due to the risk of further conflict.

And Chinese corporations are also trying to reduce their reliance on the West, and that's throwing up good opportunities. The investment challenge is to find the companies benefitting from more self-reliance and deglobalisation. We think a lot of companies will benefit from this process. Those local suppliers that are replacing imports and foreign competitors can do extremely well, and we’ve identified a few so far.

GH: On your portfolio, what are some of your largest investments by country and sector? And is it the big macro thematics you like or is it more company-specific?

AS: Well, it’s the same mistake people make thinking Asia is a high-growth market and therefore the market overall should be high growth. It doesn't play out that way and the same goes for thematics. They can dominate returns in a short period of time but there must be a follow through into profitability rather than only top line or revenue growth or volume growth. With many companies, the first phase looks good but in the second phase, most of those things fail. The trick is to identify what is sustainable. We remain fundamentally focussed so profitability is key. We know the region and we follow profitability and avoid the companies that lose a lot of money if it doesn't translate into profits. We do have companies that benefit from thematics but we follow them through profitability.

Health care looks attractive, especially as populations are ageing and they demand better health systems. One of our core holdings is a medical equipment company in China. The quality of hospitals and health services in China is insufficient, but this company has gone from reengineering Western solutions and doing it cheaper and faster, to becoming much more innovative. It spends enormous amounts on research and development. While it started as a basic assembly company, buying components and putting them together with cheap labour, they now rely less on international components and they innovative with their own end products.

Innovation is critical to China's future, and the Chinese Government is the main customer and it wants more self-reliance and innovation, and the company is now selling internationally. For example, they now sell the number one patient-monitoring device in the UK. It’s a company that can grow 20% to 30% per annum in a world where growth will become scarce. The key is not simply buying China health care due to the obvious need, because the Chinese Government squeezes suppliers of products such as common drugs or medical devices. The investing challenge is not the thematic but care in execution, as more companies fail than succeed.

GH: That’s a good example of not just buying an index or a theme but finding the best companies. Have you got another example?

AS: Well, most people do not know what a harmonic reducer is. It’s a lightweight mechanical gear that goes into a robotic arm. So here are two thematics, if you like. One is China running out of workers as the overall population is declining, the working population is shrinking, yet it’s still a manufacturing hub. The only way to deal with that problem is to automate the manufacturing processes. So we've seen an enormous growth in robots in China, and that will likely continue.

There are two sources of robots. There are international sources, which is what China started with, and then there are domestic-manufactured robots. And due to global tensions and deglobalisation, Chinese companies are sourcing more robot arms from Chinese companies. Back to harmonic reducers. A Japanese company previously held a 70% market share, then a company we own developed the same component at a 30% cheaper price. So Chinese robot makers have been shifting across, especially after the rise in tensions in the South China Sea. The last thing a car manufacturer who relies on a robotic arm wants is for one tiny component to suddenly stop arriving from Japan. Sitting in Australia, investors see China as a risk, but digging below the surface, you see what's really going on.

GH: Can we turn to the other side of your portfolio for an example of something that didn’t work well and taught you something about your investment process.

AS: Yes, although I've been doing this for 20 years and delivering consistent returns from the same process, we learn from our mistakes and there have been several stages of evolution of my process. One of our strategies is to look for positive surprises in a company's fundamentals or profitability versus what the market expects, but it requires a forward-looking view on what is going to happen, so we don’t get everything right. Six out of 10 is a good hit rate to deliver strong results for our clients.

We owned a company which was doing a lot of market research and testing of biologic drugs, their profits were being upgraded and they benefitted from COVID and the manufacturing of vaccines. Yet if you look at their share price, it peaked in the middle of last year. The share price disconnected from the earnings upgrades. When we see a breakdown in that relationship, we start to get worried. Sometimes it's just short term and you can buy that weakness. But sometimes, if it's persistent, you need to listen. And this was one of those times we thought was a short-term problem, but it persisted and we decided we didn't know what was going on. Rather than saying the share price is wrong, we exited the position. We needed to know what was driving the price.

The market can be incredibly clever. My suspicion is that the market started to worry about the longer-term earnings outlook for this company, whether the lack of COVID in the world or more importantly, the whole US/China picture and scrutiny from US regulators. That's my theory. The clouds are over the long term but we have not seen the earnings downgrades yet.

GH: So what's your elevator pitch for an Australian to invest in Asia?

AS: The key is to understand why you're buying Asia, for its growth and dynamism, and find a manager who knows what drives returns in Asia. I've only been back in Australia for about 18 months and some of the commentary about Asia is, shall we say … strange. You need to accept the volatility because it is an emerging part of the world and it's constantly changing, but with that comes opportunity. Taking an objective and forward-looking view is how you generate consistent returns over the long term.

Andrew Swan is Head of Asia (ex-Japan) Equity for Man GLG, an investment manager partner of GSFM Funds Management, a sponsor of Firstlinks.

Daniel Shrimski, Vanguard: $10 trillion manager moves into Australian super

31 August 2022

When a business that manages funds worth three times the entire Australian superannuation system enters the market, it's a sign of yet more change coming to the sector. How do its plans fit into a long-term strategy?

Daniel Shrimski is Managing Director of Vanguard Australia. He joined Vanguard in 2011 and moved to the US in 2017 to become the CFO of the US Retail Investor Group, which manages over $US2 trillion in assets for more than seven million retail investors. He returned to Australia for the MD role in October 2021. Globally, Vanguard manages $10 trillion in assets for 30 million investors.

GH: It's been almost a year since you became MD in Australia. You've worked and lived here before, but has anything surprised you this time around?

DS: Yes. First, the makeup of our business here is very different. I left in the beginning of 2017 when we were predominantly institutional with a financial adviser business. We have pivoted away from institutions to become a direct retail business that serves financial advisers. We're more mature in marketing, corporate affairs, compliance and government relations as part of the move into retail.

Secondly, the acceleration and pace of growth in ETFs has been exciting. When I left, the total market was about $22 billion and now it's about $130 billion. We're proud to be the ETF leader with about 30% of the market.

Finally, the consolidation in superannuation has surprised me, and there's better member engagement, although I think there's a long way to go.

GH: Do you mean consolidation of industry funds?

DS: Super funds across the board, encouraged by the requirements of the APRA performance test, which should give a better chance of investment success for members.

GH: Stepping away from big institutional clients must have been a tough decision because while the margins are fine, billions of dollars was involved.

DS: Yes, it was a bold decision. We walked away from the something like $100 billion of institutional business, but we did it with a long-term focus on what's the best chance for us to work directly with retail investors rather than through other financial institutions.

GH: Which leads to Vanguard Personal Investor (PI), your direct offer which was launched in Australia in 2020. What's been the experience so far?

DS: Yes, two-and-a-half years into the retail journey, we have tens of thousands of new clients, although obviously this year has been tougher than we expected but the market has changed. The data suggests we're winning market share and we've launched useful enhancements. We started off with individual account types, then joint accounts, SMSFs, company accounts, and there'll be more account types in future. We have a new 'auto invest' feature for managed funds and we plan to launch it for ETFs. Clients can put in as little as $200 monthly or quarterly and it aligns with our long-term investing approach. We build for scale to manage hundreds of thousands of clients and independent financial advisers. We have also included a lot more educational material on our new website.

GH: Member engagement is tricky because you don't want most retail investors checking their balances every day, worrying about every movement of a few percent. That might lead to repeated switching at the wrong time.

DS: Yes, trading every day is another story but as long as people are doing it responsibly with a long-term investment philosophy and we certainly don't believe in trying to time the market. For many people, superannuation is their second-largest asset and they should be closer to their super, such as knowing that small changes in costs can mean a lot over time.

GH: That's a good segue into Vanguard's plans in retail superannuation. How is that going and what will it look like?

DS: Well, we have some big news, you're the first external person to hear this, but we received our Registrable Superannuation Entity (RSE) licence today. It's very exciting for the team. We've been building the superannuation offer for about two and a half years and it's a massive responsibility to manage people's retirement savings. We'll make a public launch before the end of 2022. It will focus on simplicity, transparency, our investment expertise, high levels of diversification and low cost.

GH: That's been much anticipated. It's September now, so launch within the next three months?

DS: We think so. We will also focus on the investment experience and we've partnered with a third party that will enable us to really be nimble in employing technology and continually improving.

GH: As you know, for most younger people, it is an industry fund connected with their first workplace that captures their superannuation. Do you see Vanguard competing for that source?

DS: Longer term, absolutely yes. Incremental choice for members is a good thing, with more Australians engaged with super early. The competition will be tough but we've also got a great brand in the adviser space and we will leverage that as well as our PI platform.

GH: Back to your existing business, where have been the best flows for 2022 and have any funds done much better than you expected, listed or unlisted?

DS: One that has surprised me is our Australian Shares ETF, VAS. It held $2 billion when I left five years ago but now sits at $11 billion, the biggest ETF in Australia. Also, the range of diversified funds, where investors can access the entire market with a low minimum at a low cost, have done well. And international equities. They're the three main areas of growth. This will be the first year where we see ETF flows bigger than unlisted managed funds.

GH: On ETFs, some of your competitors make regular launches of thematic or niche funds but I don't see Vanguard playing in that market. Is that a conscious strategy?

DS: It definitely is. Our founder, the late Jack Bogle, always said, "*Don't try to buy the needle in the haystack, buy the haystack*" and in terms of launching products, that's how we run our business. New products go through a rigorous process and we look at four different elements:

One, does it have investment merit over the long term?
Two, will clients be better off over the long term with the product?
Three, is it feasible from a legal and a regulatory standpoint?
Four, is it something where we think we have an advantage over our competitors?

When you look at those four, and you run some of the thematics and cryptos through it, they don't stack up. Crypto is more speculation in a largely unregulated space and it's something we've steered clear of.

GH: And often, the thematics are launched at the peak of their popularity to catch a demand wave, such as the crypto funds that have lost 70% of their value. If we have this conversation five years from now, how will your business look different?

DS: Our strategy is locked in for that time frame and now it's about good execution.

First, we will work more with like-minded financial advisers, that's a real position of strength, including technology solutions for them around things like retirement income builders. We're also building a portal that will enable advisers to access our retail offers in superannuation and PI. We're helping advisers with their offer, their practice management.

Second, on the direct-to-consumer side, it's about growth and scale. We want a much louder voice in the retail investor and superannuation space.

And third, active and diversified funds will become a bigger part of our offering. It's a small but growing part of our story.

GH: Many advice businesses divide their clients into the As and Bs, the profitable high-net-worths, but the Cs and Ds have less to invest and are finding it difficult to access advice. Do you work with advisers across all these groups so they can service the Cs and Ds as well?

DS: Yes, and giving clients access to a low-cost personal investor offer with no platform fees is even more important as advisers are struggling with, as you say, the Cs and the Ds. We worry that advisers are leaving the industry and good advice matters for investment returns. We want advisers to be able to scale their business in terms of practice management.

GH: Final question. Do you think future investment returns will be able to match the generally good outcomes we've seen over the past 30 to 40 years?

DS: I don't really have a strong view about 10-year returns but we always encourage clients to stay the course. Although we do see a 40% to 50% chance of a recession in Australia over the next couple of years, nobody knows how much of that is already priced into the market. Vanguard has been in Australia for 26 years and we're not focussed only a few months ahead. I couldn't be more excited about the growth opportunity in the retail space in coming years as many fundamentals work in our favour.

Daniel Shrimski is Managing Director of Vanguard Australia, a sponsor of Firstlinks.

Adam Grotzinger, Neuberger Berman: How diversified bond portfolios yield 7%

20 July 2022

The rapid rise in US Treasury yields and widening spreads on almost all other types of credit have pushed down bond prices, but it now means diversified bond funds can give investors returns not seen for many years.

Adam Grotzinger is a Senior Portfolio Manager for Neuberger Berman's Strategic Income Fund, widely available on Australian platforms. Neuberger Berman manages about US$440 billion across all asset classes in 35 offices worldwide, including Sydney.

GH: It's been a difficult time for investors with global stockmarkets down 20% and major bond indexes off 10%, even US Treasuries. Is it a 'nowhere to hide' period for investors?

AG: Yes, in the wake of the so-called 'interest rate normalisation' from very low government rates and the supply-demand imbalance after Covid, there's a stark recalibration in yields and spreads that have hit both bonds and risk asset globally.

GH: You manage the Strategic Income Fund. How has the macro environment affected the way you've positioned the fund?

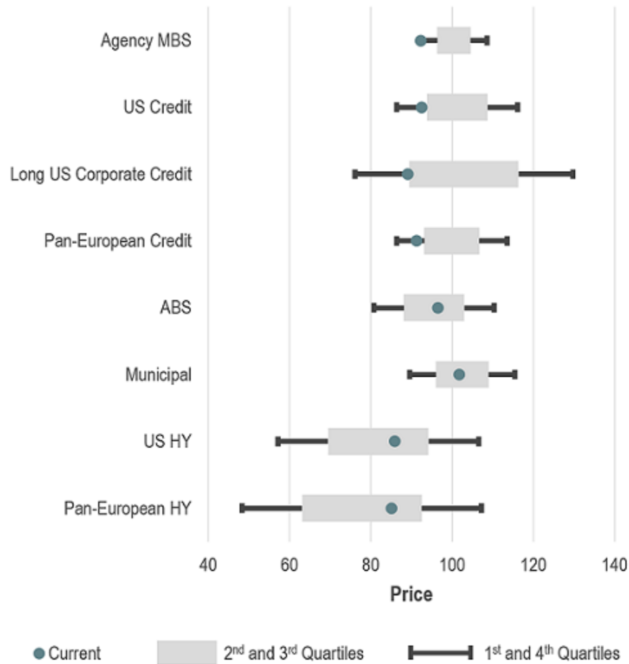
AG: When we were winding down 2021, we had a view that 2022 would bring a lot of macro, central bank-induced volatility due to the lift off from the zero boundary of interest rates. It then happened in quick order and sizable magnitude. So in Strategic Income, we brought down the risk budget of the fund in Q3 and Q4 of 2021, we reduced the high yield exposure and the market value of exposure, and we increased to about 20% cash and cash equivalents as ballast. We were largely invested but feeling good about on a line-by-line basis on the credits we owned coming into choppy waters.

But we've also evolved from concern about interest rates and macro trends to increasingly economic and growth worries, so we've been gradually redeploying capital back into the bond market where we think there's good value. It's mainly in investment grade assets largely in the US. As a result of the adjustment factors, they yield attractive margins and we see value at these levels. We have good quality corporate debt at 150 basis points (1.5%) over Treasuries, triple-A agency mortgages with coupons of 5%. It gives us a portfolio yielding around 7% for an average credit quality of A-minus. Cash is down to 7% so we still have some dry powder.

GH: This availability of 5% to 7% yields is something investors haven't seen for many years. Do you think credit markets are closer to pricing in a recession than equity markets?

AG: Well, right now, we see better relative value on a multi asset basis increasingly in fixed income. The adjustment has occurred in short and swift order and the risk/return looks attractive, even if we have a technical recession in the US.

For instance, the US high yield market spreads have offered 500 to 600 basis points (5% to 6% above Treasuries) and that level of compensation is out of kilter. It is pricing in a much worse environment for defaults than we are modelling from a bottom up, issuer-by-issuer analysis. So we have a different takeaway there from the market and that's leading us to see better value. It started in favour of investment grade but it's seeping into the lower quality credit end.



Source: Bloomberg. Ranges represents 20-Year High/Low. As of June 2022.

GH: Even when you expect higher yields and wider spreads, you essentially need to stay invested to generate income despite some price deterioration. Do you need to communicate to clients that this year is more of an income story than a capital gains story?

AG: Yes, setting expectations is spot on for the environment we're in and the objectives for a multi sector bond fund. We embrace market volatility, but the distinction is that we don't want to embrace impairment risk by poorly underwriting credits. So there's some short-term volatility in the fund but the medium-term objective is to make the opportunities work for our clients. Expectations need to be set.

Since before the GFC, after the top five drawdowns (falls in price) in the Fund, the following 18 months more than recovered those losses. We need prudent amounts of risk so we're not forced liquidators of credits and with ample liquidity to buy assets on the cheap. It has enabled us to recover more than the temporary marks down.

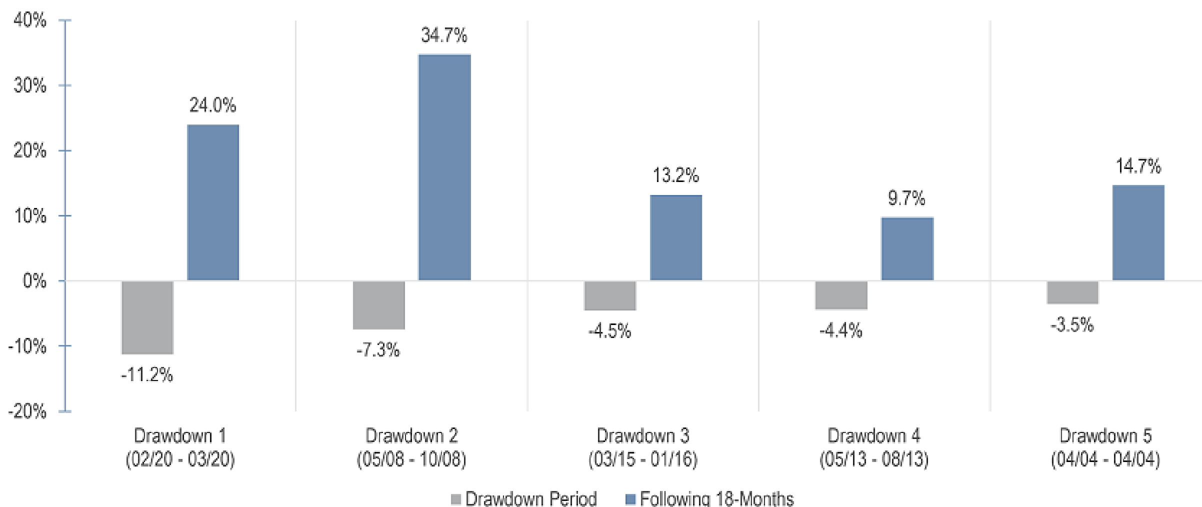
GH: Do you own any Australian securities?

AG: Not today in the Strategic Income Fund but it has been a market we've used in the past. In looking for compelling relative value on a global basis, the portfolio is anchored on the US market given the macro environment and the greater growth opportunities versus say Europe, for example.

GH: Does the massive strength of the US dollar, now at parity with the Euro, influence your positioning?

AG: No, currency is not a big part of how we reach our objectives. It's more about bond returns and relative value opportunities.

GH: Looking at aggregate fund flows in fixed interest, we've seen outflows globally in the June 2022 quarter. What was your experience, and do you find it a little frustrating that when there is finally some value in fixed income, investors leave the sector?



Source: Neuberger Berman, as of 31 March 2022

AG: Well, I let the market determine where capital goes, but it is frustrating when we think there's good value after a painful readjustment process. We recognise the path to that value has been painful for some clients. We've been fine on flows, we have a long history of managing daily traded vehicles and we respect the needs of clients to adjust their asset allocations.

GH: Many active manages talk about downside protection. What are the key steps in 2022 and 2023?

AG: We're entering a period of below-trend growth, a coin toss on recession, with policy volatility. We need to get the fundamentals right and credit selection and managing risk budgets and liquidity are big parts. When the yield is close to 7% on A-minus quality, that is accruing strong income which will be a major component of returns.

GH: Can I understand better where this 7% comes from? It's higher than my top-of-mind understanding of where yields are. What are the securities included?

AG: Let's start with the US aggregate bond index, leaving aside global for a simple reference. It includes only investment grade securities and that's yielding (on a so-called 'yield to worst') today 3.7%. Treasuries are at 3.1%, securitised products like mortgages are 4.5% to 5%. Investment grade corporate debt is yielding upper 4%, close to 5%. Then depending on where you go in corporates, different levels of maturity and quality stack, into diversified, non-investment grade offering today a yield around 8.5%, a spread over government bonds of 5.5%.

A lot of the return is coming from the massive correction in Treasury yields. It's not hard to construct a quality portfolio earning 5.5% in investment grade assets, and 7% in a broader portfolio.

For more detail, see Neuberger Berman's Q3 fixed income outlook.

Adam Grotzinger is a Senior Portfolio Manager for Neuberger Berman's Strategic Income Fund. Neuberger Berman is a sponsor of Firstlinks

Chris Demasi, Montaka: Why short-termism is both travesty and opportunity

6 July 2022

On any given day, whether the stockmarket rises or falls is a coin toss, but stay invested for 10 years and the odds are excellent. It's at times of market selloffs that opportunities present for long-term investors.

Chris Demasi is a Founder and Portfolio Manager at Montaka Global Investments, a global equity manager with staff in Sydney, Melbourne and New York and managing about $300 million across two ASX-listed active ETFs and an unlisted fund.

GH: You've been writing on the need to invest and think long term. Would you describe short-termism in equity markets as the biggest problem facing investors?

CD: Absolutely. The myopic nature and increasingly short-term views mean investors are taking their cues from short-term movements in stock prices, and that's how they measure the success of their fund managers or the companies they invest in. The geopolitical and financial market uncertainty makes horizons shrink and it's a travesty, but it also creates a lot of opportunity for people who stay the course, pick up bargains and hang in for the long term. I say travesty because they forgo a lot of the extraordinary gains they could otherwise make by staying the course and focussing on a long-term view. They should be thinking about the fundamentals of the business and the opportunities in front of them rather than short-term share price fluctuations.

We use a chart which shows over the long term, the chance of a positive return on a daily hold of the S&P500 is only 53%. But go out to one year, and it's 75%, then five years is 88%, 10 years is 94% and there are no negatives over a 20-year period.

Stock market performance over different horizons

S&P500 return frequency, percent

Horizon	Total Periods	Positive Periods (%)	Negative Periods (%
Daily	23,529	53%	47%
Monthly, calendar	1,104	63%	37%
Quarterly, calendar	368	69%	31%
1-year, rolling monthly	1,093	75%	25%
5-year, rolling monthly	1,044	88%	12%
10-year, rolling monthly	984	94%	6%
20-year, rolling monthly	864	100%	0%

Source: Fisher Investments; Global Financial Data, Inc. Daily return data begin on 31 January 1928 and are based on price appreciation only; all other data begin on 31 January 1926 and reflect total returns to 31 December 2017.

GH: Do you believe good opportunities still exist in today's market of inflation, rising rates and a fear of recession?

CD: Even today, we see many examples where excellent companies have expanded their addressable markets, they are growing their revenues, their earnings power is increasing, often exponentially. The business value is going one way but the share price is moving completely opposite. And therein lies the opportunity for investors that stay the course.

Go back to the experience of Alphabet over the last decade. It's a company that has grown earnings by seven times and over a decade, it's an eight-bagger, but few shareholders would have retained it over that time. They are too busy timing the buying and selling but if investors had simply followed the path of the earnings power and the business fundamentals, they would be rewarded handsomely. Alphabet's share price is down 22% in the last quarter. There have been periods where the stock has gone down by 30% and it's often fallen by 15% but that's the cost of entry to the opportunity.

GH: Yes, and the same with Amazon that had a 90% drop in the tech wreck, but how many people hung in through that experience?

you look at the best companies, such as Apple, Amazon and Microsoft, their future earnings potential continues to grow.

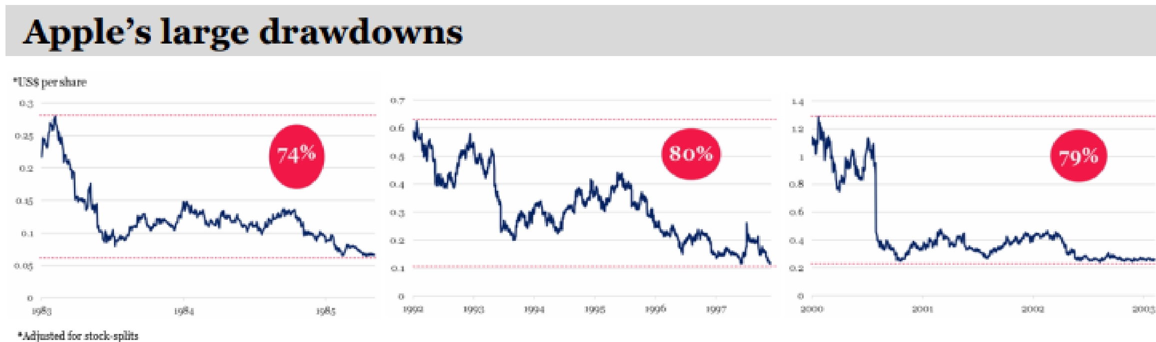
GH: You've also written about how long-term returns are driven by surprisingly few companies and the majority don't contribute over time. So it's not a matter of simply investing for the long term in anything.

CD: In our analysis over 10-year periods, most companies don't hold their value and only one in four stocks turn $1 into $5 and one in 16 turn $1 into $10 and it's those that create all the value in the stock market. So to deliver superior compound returns over a decade, we need to focus on finding outstanding businesses leading transformations in their markets, and buy them when they're undervalued.

GH: Is this message of accepting the inevitable drawdowns resonating with your clients?

CD: It's always a difficult message and that's a reflection of human nature, we just don't like to see prices go down. But, yes, the message resonates when we present the evidence as it builds a degree of confidence that this is the right way to approach equity markets.

GH: But what might you also look for as an exit point for



CD: Yes, and we don't wish for falls like that, but Charlie Munger and Warren Buffett say that if you can't tolerate a 50% sell off, you shouldn't be investing in equity markets. Morgan Housel says in *The Psychology of Money* that volatility is the price of admission and the prize is superior compound returns. While some of these drawdowns can be painful and nobody wants them, the best performers have all had large drawdowns. In fact, Apple has had three.

Investors need to understand this to give them confidence to stay the course, but not in every company. It applies for excellent companies that have opportunities to grow exponentially for long periods of time when their leadership positions and moats are sustainable.

There are great examples of that not being the case. Peloton had a pull forward in demand during the pandemic for their digitally-enabled bikes but the fall in its stock price has been led by an earnings drop. The same is true for some bricks and mortar retailers such as Bed Bath & Beyond in the United States with unsustainable earnings estimates. But if

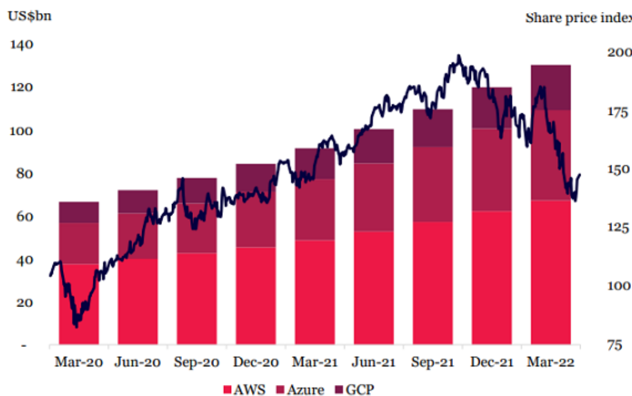
some of these companies, because if you if you look at an Alphabet or Microsoft, there's a case to own them forever?

CD: This is our playbook. If the thesis changes or something happens that we don't understand, that triggers a review of the position. It might be competition or regulatory change or something else that disrupts a leadership position. Or if the market size is not evolving as we expect and the growth potential is lower or riskier than we thought. And of course, the one that we like is if the price goes up a lot more than we can justify. We have a good example in Microsoft at around US$250 today. We think the business will reach a value of US$1,000 to US$1,200 over a decade based on growing cash flows into future, so we're playing for four or five times in 10 years for one of the highest-quality companies in the world. We take a 'private equity'-like approach to public markets, so if the public equity market takes Microsoft to US$1,000 by the end of the year with nothing else changing, that might trigger a sell because that was all of the upside we were playing for.

The flipside is that if we still believe in the thesis but the share price halves, now we're playing for a 10-bagger. We might have capacity to add to our position, and investor with money on the sidelines can improve the future return potential.

GH: How do you weigh up for the geopolitical and macroeconomic factors that also feed into the market, as well as the company specific?

CD: Because we focus on a concentrated portfolio of opportunities, we think less about geopolitical events and macro. We appreciate they can change the mood and sentiment in the market but if it doesn't change the drivers of business value and earnings power over time, then it's much less relevant in most cases. Extending the Microsoft example, virtually all the increase in value over the next 10 years will come from cloud computing and artificial intelligence, and that's not dependent on a war in the Ukraine or inflation or interest rates over that time. We don't typically change the portfolio to play the short term.



(Note, AWS (Amazon) holds 33% of public company cloud market share, Azure (Microsoft) holds 21% and GCP (Alphabet or Google) holds 10%).

GH: You're a global equity manager but do you have any Australian stocks in your portfolio?

CD: We've held REA Group for a while. It's one of the world's best businesses, which sounds funny because it's in a small pocket in a corner of the world but it's almost a monopolist in an industry that favours winner-takes-all, and it still has room to grow as we shift from offline to online. It will take a greater share of real estate marketing budgets. It's not a Microsoft or Alphabet but it's an excellent position and it's still a growth business.

GH: You have two ASX-listed vehicles, the Global Long Only (ASX:MOGL) and the Global Extension (ASX:MKAX). What does 'extension' mean and what's the difference between these two funds?

CD: They both invest in the same core portfolio of stocks and today there are 23 stocks so it's a concentrated portfolio with the top 10 making up about 70%. The extension allows us to run a small short portfolio of companies we believe are in trouble or in industries that will deteriorate over time, and that's about 30% worth of the portfolio. We use the proceeds from shorting to apply more exposure to the core portfolio of 23 on the long side.

GH: Okay, it's typically a 130/30 fund of your selected winners and losers. Can you give an example of a stock you like but has disappointed and it made you think about any lessons you might learn about your investment process?

CD: The biggest lesson is the other way around, where we have let go of one of these high-quality compounders too soon. We've been too sensitive to a run up in prices, for example, selling Apple and Microsoft. The trick is to recognise the difference between price and value and stay the course and not be tempted to sell out, either up or down. We're less inclined now to take shorter-term profits because we're playing for so much more in the future.

GH: Is there a company that you expect to own for the next 10 years or longer?

CD: Almost all the companies in the portfolio, unless the public market gives us an opportunity to reap the multiples we expect much sooner. An example is Blackstone, the private capital and alternative asset manager. We can see so many new market opportunities for them not captured in the current valuation. They're only just starting as far as money allocated to the alternatives sector is concerned. Institutions are underweight private capital and the retail market of private banks and clients is an US$80 trillion untapped opportunity. Blackstone's been building distribution and sales for the last 10 years. We expect them to manage many trillions of dollars in the years ahead but the macro themes and lumpiness of asset accumulation will test investor patience and staying power, while throwing up opportunities to buy more shares.

GH: Final question. If valuations are so good at the moment, what are doing with your own money?

CD: I can't understand the divergence between the business values created in the companies we hold in the portfolio and the selloff in their stock prices, so sharp and dramatic. Microsoft down over 20% year-to-date, Amazon even worse, 35%. We've been putting more and more of our own money into our funds and will continue to do so. We're eating our own cooking.

Chris Demasi is a Portfolio Manager at Montaka Global Investments, a sponsor of Firstlinks.

Eric Marais, Orbis Investments: Time for value as ‘promise generators’ fail to deliver

29 June 2022

A $28 billion global manager still sees far more potential in value than growth stocks, believes energy stocks are undervalued including an Australian company, and describes the need for resilience in investing.

Eric Marais, CFA, is an Investment Specialist at Orbis Investments. He joined Orbis in 2013 and is a member of the institutional client servicing team and retains portfolio responsibilities in the investment team. He spoke to Firstlinks from his San Francisco office. The Orbis Global Fund started in 2005 and holds A$28 billion including $2.5 billion in Australia.

GH: The strong growth market between 2018 and 2021 didn't suit the Orbis style but relative performance has improved in 2022. How do you read the current market conditions for your Global Equity Fund?

EM: Yes, it's definitely better. We’ve seen some recovery of value shares versus growth. What is less talked about is that over the last 10 years, most of the returns in the global index have come from the US. And we’ve been underweight US for some time because we found better value outside of the US as bottom-up stock pickers. So, in addition to value, the other thing that’s changed recently is the US underperformed a little.

(Editor's note: 'Value' investors typically look for shares trading below their estimated intrinsic value, or companies which look inexpensive on metrics such as low multiples of their profits or assets).

GH: It’s been amazing to watch many US companies that did so well in those years up to 2021 are now down so much. About 300 of the Russell 3000 companies are down 80%, not just 20% or 30%, well-known names such as DocuSign and Rivian. And Amazon is off 30%, Meta 50%. Are you seeing any value in the tech or disruptor space now they have fallen so much?

EM: Yes, in technology broadly defined. With some stocks you simply can’t argue that they are expensive anymore – a company like Alphabet that's very profitable, very cash generative, growing much faster than the market, yet trades at a P/E multiple slightly above market level. On the other hand, the Rivians of the world have unproven businesses that received funding.

GH: And despite building hardly any vehicles …

EM: Exactly. The last decade, with its ultralow interest rates, was a perfect funding environment for speculative business models. Many of the stocks that are down by as much as 90% have never generated $1 of free cash flow. It's hard to argue they are cheap despite the sell off. Who knows how those business models will pan out? I'm sure there will be a handful of great stocks in there but the average or median stock will not be great.

We distinguish between ‘promise generators’ like the Rivians of the world versus ‘cash generators’ which are real cash-generating tech companies that trade on reasonable multiples today. They’re starting to look more attractive. We constantly compare them to the rest of the investible universe but less so the unproven ‘promise generators’.

GH: Your Global Fund allows up to 25% in emerging markets. It’s a sector that always seems to have potential but rarely delivers. Has it been a disappointing experience for Orbis?

EM: Lately, yes, but if we take a step back, while buy-and-hold hasn't done well in emerging markets, the returns during recoveries from global crises have been better. We don’t buy regions as a whole - just a handful of stocks.

However, our Chinese shares have suffered in the last year from China’s 'common prosperity' move. One of those, our investment in Naspers, gave us discounted exposure to Tencent so you can see the appeal for a value-oriented contrarian manager. However, that discount has gone even wider in the last year to well over 60%. We’re still excited about its valuation, we still own it, and it’s recovered in recent weeks but we needed to balance the bottom-up view against China country risks. We reduced the position size over the last year to reflect that, which is the most painful thing a contrarian manager can do.

GH: How do you balance such big macro themes, like China, with the merits of individual companies?

EM: We invest bottom up so we almost always start with the specific company first, and look at what has done poorly. Allan Gray, our founder, said that when looking for stock ideas, you should forget about the best-performing half of the market and focus on the worst-performing half over the last five plus years. That’s where our contrarian

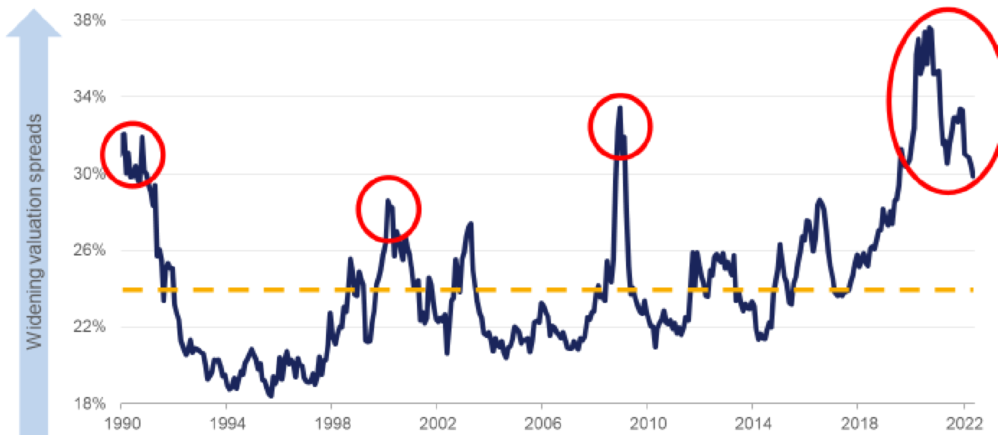
Value shares are cheaper than usual: US, last 50 years

Ratio between the top third and bottom third of shares in the S&P 500 ordered by price to book

31 May 2022 | Source: S&P Global, Orbis. Statistics are compiled from an internal research database and are subject to subsequent revision due to changes in methodology or data cleaning.

Value shares are cheaper than usual: worldwide, last 30 years

Spread of expected return between the top half and bottom half of shares in the FTSE World Index ordered by expected return



31 May 2022 | Source: Worldscope, Orbis. Statistics are compiled from an internal research database and are subject to subsequent revision due to changes in methodology or data cleaning. Spread is the dispersion of expected returns in the market as a whole. Expected returns are estimated using an internal proprietary model.

approach comes from, where we've seen something going wrong. Then we marry that with macro in our risk process because we know big macro risks can impact the whole portfolio.

Value shares still look cheap to us, although they were probably cheapest this time last year. One of our internal measures tells us that it's still on par with every extreme except the height of Covid.

GH: Last time I spoke to Orbis, in August last year, the only Australian company in the Global Fund was Newcrest. Why does Australia rank so low?

EM: We now own Woodside as well. We have about 3% of the Fund in Australia, or a little more than the global index. The simple answer is that we have a wide opportunity set of about 5,000 companies we can invest in, and we find stocks that are more appealing to us. For example, we also own Shell but an Australian investor might only consider Woodside.

GH: You've been underweight US stocks, do you expect that to change in future?

EM: It is a significant underweight of about 20% or so versus the weighting in the global index. Another way to look at it is that we're underweight technology shares which make up much of the US weight in the global index. So our view is more about the companies than the country and where we find value.

GH: When you talk to clients, how do you explain your contrarian style? Isn't an emphasis on unpopular companies a difficult story to tell, with the cyclical underperformance that comes from it?

EM: We're not contrarian for its own sake. We believe that to outperform the market requires a meaningfully different portfolio from the market by doing something different. Adam Karr (President and Head of Investment Team) likes to say "*It works because it hurts*". We think this is the way to outperform, but it can be challenging to an individual

investor's psyche and not everyone can do it. The firm also needs the right structural elements that allow us to execute the investment philosophy. For example, we are privately held and employ refundable performance-based fees. Our clients are well-aligned and understand our approach.

GH: So do you need a certain type of personality to be an Orbis Portfolio Manager?

EM: I think so, yes. They need to think independently and be willing to look wrong for extended periods of time. Investing our way will go against you, and if you start to feel uncomfortable, that will affect your decision making. A huge amount of our value add comes from sizing up during times when stocks have performed poorly so you want to be in a mental position to lean into things that have done poorly to maximise the benefit when they recover.

GH: A mix of humility and resilience.

EM: That's a good way to put it.

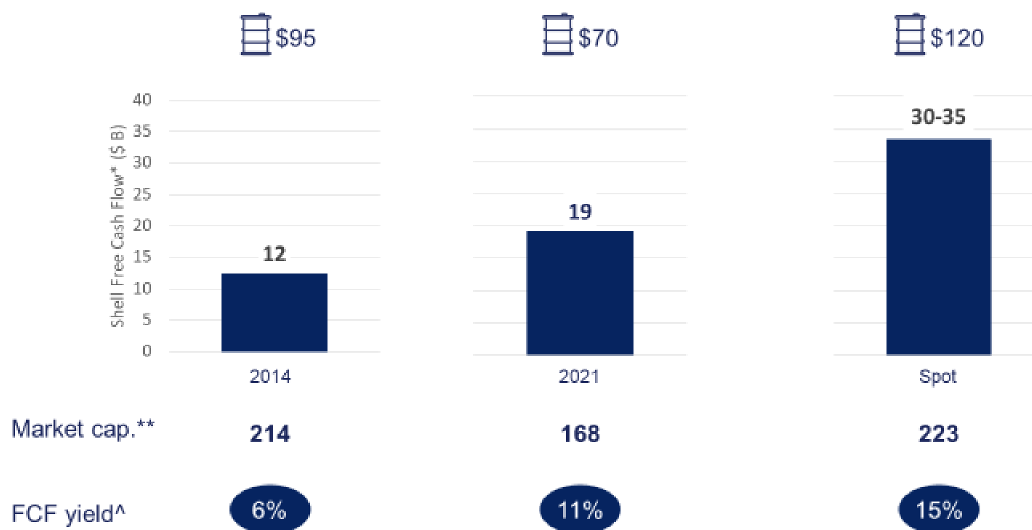
GH: Is there a stock in your portfolio that you're so confident about that you would expect to own for say 10 years?

EM: 10 years is a big commitment. Outside of marriage and children, I'm not sure I'd go that far. NetEase is an example that we've owned continuously for maybe 12 or 13 years. Another longstanding holding is XPO Logistics, which spun off GXO in 2021 and we continue to own both companies. A major reason is that they are run by owner-operators, such as William Ding at NetEase and Brad Jacobs at XPO. XPO is Brad's third public company. We'll watch it carefully if he goes for number four.

GH: Final question, is there a theme where you're seeing good opportunities?

EM: Although energy prices such as oil and natural gas are high, we don't think company share prices are valued highly enough relative to normal energy prices, and certainly not relative to spot energy prices. For both Woodside and Shell, we estimate they are trading in the ballpark of seven or eight times free cash flow. That looks very attractive compared with their growth prospects which could justify a low teens multiple of free cash flow. We can have a debate about the sustainability of spot prices, but the free cash flow of around 15% is being returned to shareholders, not reinvested in the ground to increase supply. It's a good setup for shareholders, even if spot prices are not maintained forever.

Eric Marais is an Investment Specialist at [Orbis Investments](), a sponsor of Firstlinks.



31 May 2022 | Source: S&P Capital IQ, Orbis. *Defined as Cash Flow from Operations less Cash Flow from Investing, excluding asset sales, in USD billions. **Market capitalization, as of last day of indicated year, in USD billions. Spot is 31 May 2022. ^Defined as stated free cash flow divided by stated market capitalization. Oil prices shown are approximate averages over last 12 months for indicated years (aside from spot), using brent crude prices in USD.

Steve Bennett, Charter Hall: The latest trends driving commercial property

8 June 2022

Commercial real estate still offers good yield pickups versus bonds, but some sectors are better positioned than others. What types are resilient in the face of rising inflation and interest rates?

Steven Bennett is Chief Executive Officer of Charter Hall Direct, part of the Charter Hall Group (ASX:CHC), and is responsible for funds under management of over $10 billion in unlisted property funds.

GH: Which sections of commercial real estate are most resilient to rising inflation and interest rates?

SB: Any asset class that can exhibit strong income growth or pricing power is generally resilient to inflation and interest rates, regardless of whether you're talking equities or commercial property. A key advantage of Australian commercial real estate is the fixed rent increases. They may be CPI or a fixed percentage but contractually, they're locked in on an annual basis. For example, our $3.2 billion Direct Office Fund has annual average increases of 3.6% which in the context of long-term inflation targeting by the Reserve Bank of 2% to 3% is attractive. Many buildings have 'triple net leases' where the tenant is responsible for building outgoings (see explanation in previous interview).

GH: Do many of the leases build in CPI increases?

SB: Of the $61 billion of real estate that Charter Hall manages, about 25% is CPI-linked, 24% is triple net leases and the balance is a combination of fixed rental increases. It varies by fund. The best protection is to have pricing power in your assets. In an office building, that means prime institutional-grade assets, with good amenity, cafes and restaurants, close to public transport, strong ESG. In the industrial space, proximity to infrastructure, toll roads, motorways, ports. These features give the ability to protect the rental yields, but secondary or lower-quality assets where there's a lot more choice and people don't necessarily need to be in those assets long term are more difficult.

GH: Is there a part of the market which doesn't have this level of pricing power?

SB: In the last few years, although we're not really in this space, the large discretionary malls with tenants that are competing against online entrants have had a difficult time maintaining headline rents, and some of those asset values have come off 15 to 20%. At the other extreme, the small neighbourhood shopping centres anchored by a Coles, Woolies or Aldi are extremely resilient. They continue to increase their sales turnover and it's been a good story for investors in non-discretionary retail.

GH: Yes, we still need to buy groceries. We all know about the labour and materials shortages on the residential side, but how has it affected your business?

SB: We have a large development pipeline across the Charter Hall Group, roughly $12 billion spread $7 billion in office and $5 billion in industrial logistics. But because we're building to own the assets long term, and not necessarily for speculative development, we approach our developments differently. We've de-risked them wherever possible with pre-committed leases, we use fixed price building contracts and we only employ tier one building firms that are financially strong.

We also benefit from experienced development teams, and they've been on the front foot ordering components and parts. For example, at 60 King William Street, our new Adelaide office development, we ordered the plant and equipment early. At 555 Collins Street in Melbourne, we have 13 levels of glass facade in storage in Australia. It reduces the supply chain issues that are coming out of Asia and China in particular.

GH: Do you have a view on when these global supply issues might return to 'normal'?

SB: Lots of variables there. Shipping costs are still elevated, higher building costs especially in locations outside Sydney and Melbourne. We are expecting prices to stabilise later this calendar year and through into 2023, but it's dependent on globally moving away from Covid-zero policy settings.

GH: What are some of the global trends in commercial property that we might see more in Australia?

SB: Offshore the build-to-rent or multifamily sector is continuing to develop. Additionally there is a large and growing focus on allocations into property which are underpinned by data centres, biosciences and a renewed focus on health and education facilities.

GH: Biosciences, that's like the big facilities producing vaccines, that sort of scientific work?

SB: Yes, exactly. We've got an asset that does the Red Cross blood distribution at Alexandria in New South Wales, strategically located near the airport. They can move highly

perishable items at short notice and they have 24-hour deliveries coming and going from that centre.

GH: If you think back to pre-pandemic days, say three years ago versus now, what have been the major changes?

SB: There's more focus on tenant quality than ever before, finding tenants that are financially strong, with good balance sheets, ample free cash flow and strong demand for their products. For example, with our own PFA Fund in the office market, 60% of the rent is paid by federal and state government entities. Our two office funds are attracting equity investments because of that.

I do think some people have made strategic mistakes underestimating CBD activity. They moved their small offices to working from home a two-hour commute from the city but they are missing the eye-to-eye personal contact involved in winning business. There are great things about working in the CBD.

On the ESG side, particularly the 'E' for environmental, we receive questions from investors on whether our properties or the tenants within them are delivering positive environmental outcomes. In the office markets, there’s a major flight to quality with prime space seeing the lion's share of tenant demand, and there’s an increased obsolescence risk for inferior offices. In industrial and logistics, there is a turbocharged universe with three trends around onshore versus offshoring, just-in-case inventory versus just-in-time inventory, and the continued growth of ecommerce. In retail, people now have a greater understanding of the difference between discretionary and non-discretionary retail.

GH: So what’s happening with B-grade office buildings?

SB: Tenants want space that hits their environmental rating, and it's very difficult to deliver those standards on B- and C-grade assets. The capital cost can be prohibitive and sometimes you functionally just can't do it. And if a company wants its team back in the office, it needs a more flexible workplace, areas that encourage collaboration, where staff want to work in a pleasant space with great natural light. If you're not offering those things, why would staff want to come back into the office? So the pandemic has sped up the risk of obsolescence in the lower quality assets.

GH: Charter Hall offers both unlisted and listed funds. If an investor is looking for exposure to property, does the business make a case one way or the other?

SB: We don't believe that one form of property investment structure is inherently superior to the other. We do run three large listed property vehicles (retail ASX:CQR, social infrastructure ASX:CQE, long WALE ASX:CLW) and of course, our parent is listed (ASX:CHC). We encourage people to check what structure suits their requirements. Liquidity is a key benefit of the listed market, but if an investor wants less variability in returns and prices linked more to the underlying value of the properties, then unlisted may be the way to go. It depends on the desired investment outcome. I've got both in my own SMSF because I don’t want my entire portfolio doing the one thing, they work together.

GH: I'm the same. One aspect I like about the unlisted segment is it’s easier to set-and-forget, there’s no daily sharemarket asking me to assess the price and I expect I'll just leave money there for decades. I want some of that as a core in my portfolio.

SB: Yes, and it does stop people from exiting the market at the worst possible time. For example, we have 10 funds in the direct suite, and the returns over the two-year period from March 2020 to March 2022 - completely pandemic-impacted - show the lowest return was 12.6% per annum and the highest return was 28% per annum. All other funds fell somewhere between. But if there was daily liquidity a lot of investors would have exited at the start of the pandemic and missed those great returns. So there is a lot of value in what you just said, take a long-term approach without assessing your investments each day.

GH: While no parent can have a favourite child, do you think there's a specific fund in your suite which is looking the best at the moment?

SB: We don’t like to give investment advice, even in interviews like this, so let me describe some trends and allow people to draw their own conclusions. The biggest growth is in the Charter Hall unlisted Long WALE (Weighted Average Lease Expiry) Fund. It's diversified, pays monthly distributions at a rate of 5.4% per annum, and we pick the sectors we think will deliver the best medium- to long-term returns. The biggest flows by quantum are into the Direct Industrial Fund number four (DIF4) with industrial logistics and those three key thematics I mentioned before. And it may surprise people that we've raised over $250 million in our Direct unlisted office funds in this financial year, with many investors looking through the short-term noise around the pandemic.

GH: I know the management team would prefer to focus on the day-to-day business rather than worry about the Charter Hall share price, but it’s been amazing to watch it go from $14 in early 2020, down to about $5 in the pandemic, then soar to $22 at the end of 2021, and now back to $13. It's been a rollercoaster, despite the business consistently growing. What’s the feeling in the business? Is it frustrating that the market reacts with such extremes?

SB: We know that listed markets can be volatile and ultimately, we don't price the stock, the market does. The leadership team at Charter Hall focusses on driving the earnings. That's the one thing we can control, and we

believe that over the long term, the share price will follow earnings. Over the last five years, we've delivered EPS growth of 25% per annum and we aren't caught up in the day-to-day share price. Our underlying funds continue to perform and that's why we've had such strong success in raising capital.

Steve Bennett is Chief Executive Officer at Charter Hall Direct and was elected President of the Property Funds Association in April 2019. Charter Hall is a sponsor of Firstlinks.

Reece Birtles, Martin Currie: Selecting stocks for income in retirement

1 June 2022

Equity investing comes with volatility that makes many retirees uncomfortable. A focus on income which is less volatile than share prices, and quality companies delivering robust earnings, offers more reassurance.

Reece Birtles has been Chief Investment Officer at Martin Currie Australia since 2006 and is the lead Portfolio Manager on several funds including the Equity Income Fund. Martin Currie is a Franklin Templeton investment manager.

GH: In your presentations, you talk about having 'sufficient income for life'. How does this investment method differ from other equity income funds?

RB: Going back to the late 2000s, a few of us in the investment team had parents approaching retirement and it was also the time of the GFC with massive market volatility and uncertainty. There was a perception that equity portfolios were very risky, so we set about designing a portfolio specifically for Australian retirees and their circumstances. When a typical couple retire, they might have about $600,000 in superannuation and they need about $50,000 a year of income to support their standard of living. They want the $50,000 to grow with inflation over time as they still have a very long life expectancy.

GH: What are you assuming about age pension entitlement?

RB: Yes, they are probably eligible to get the pension of about $20,000, so that means they need about $30,000 a year from the super portfolio. As an investment objective on $600,000, we need to generate about 5% to give $30,000, but more than aiming for a percentage income, we want to produce $5 on each $1 growing on a steady and reliable basis, faster than inflation. That's what we think is a sufficient income for life for an Australian retiree.

We also want to reduce the risk and the variability of that income. We take franking into account and we ignore the benchmark weight for individual stocks and sectors. We don't want 40% of the portfolio in one sector where all the dividends could get cut at one time and we don't want 15% in one stock. We're building a highly diversified income stream that can grow over time.

GH: You are asking retirees to think in terms of income rather than volatility. Do you think this message and the strategy has worked and is understood?

RB: The standout feature of this equity income strategy compared to say a term deposit as a retirement income investment is that the latter has fallen by about 80%. So the income volatility of a term deposit is amazingly high, even though it is capital stable. Whereas when you look at equities, whilst the share price volatility might be 15% to 20% per annum, the variability of the dollar income stream from the dividends of companies has been significantly lower. The COVID year was a big challenge to dividends and the income stream on our strategy was down about 20%. It was significant but far less than the 34% fall that the ASX200 dividend stream suffered. The income stream has now fully recovered, driven by the diversification and owning high quality companies.

GH: In the last six months, there has been a change in the investment environment with an acceptance that inflation is rising, central banks increasing interest rates and now a war in Europe. Have these factors changed the way you're investing?

RB: In the current environment, there's more appeal in industrial-style businesses that can pass on price increases to their end customers, given demand is strong and they're not impacted by travel restrictions. Commodities have more appeal, and we're also looking at names such as Aurizon (ASX:AZJ) where demand is locked in and, if anything, improves with the current market. We look for regulated assets where inflation flows through to increases in prices automatically.

GH: Are there other Australian companies you feel have this strong pricing power and can withstand the inflationary shock.

RB: We like Medibank (ASX:MPL), it has a strong market position and lower cost to serve than its competitors. While there are always discussions about private health insurance increases, it’s the best player in a regulated business. It’s the type of resilient income stream we look for. We think Telstra (ASX:TLS) is strong, mobile phones are not a discretionary purchase and the demand for data is always rising. We also look at companies which benefit from change, such as the demand for renewables construction and a name like Downer (ASX:DOW) has improved the quality of its business and become a more reliable dividend-paying company.

GH: So how does Equity Income differ from the Real Income Fund, launched in 2010 with positive returns every year except 2020? And what happened in that year around COVID?

RB: The Real Income Fund is designed with the same purpose for retirees to have a stable growing income stream, but it is focussed on what we call hard assets or real assets, such as property, infrastructure and utilities. The idea is that they're less susceptible to the business cycle and they have pricing power with mechanisms on tariffs or rents and they benefit from population growth over time. In 2020, COVID changed the circumstances for many of those assets significantly, such as consumers not able to go to shopping centres and less travel on toll roads. There was even a reduction in demand for electricity and gas due to industrial closures. But income streams and dividends did significantly better than share prices, and then the income recovers as the economy reopens.

GH: Does that Fund have fewer opportunities in Australia with ongoing privatisations, such as Sydney Airport and CIMIC leaving the ASX?

RB: Yes, it's true that a some high-quality companies have been privatised given how attractive these real assets are in an inflationary environment, so we’re increasingly looking to offshore stocks such as Zurich Airport to find suitable replacements such as for Sydney Airport while retaining a predominantly Australia-orientated exposure.

GH: We're seeing a stock rotation in Australia with some hefty corrections in company share prices that did well over 2020 and 2021 but are there market segments that you consider expensive or cheap at the moment?

RB: There’s still one of the biggest distortions in markets as the price of typical value-type stocks versus growth-type stocks has been extraordinarily wide. If you look at the Price to Earnings (P/E) ratio, for example, of the MSCI Growth Index versus the MSCI Value Index, we're coming off one of the most extreme events.

The biggest dispersion in P/Es have been in the tech bubble, during the GFC and in 2020. Clearly, that has started to reverse, but we started with a P/E on the Growth Index in excess of 30 times and the Value Index was around 15 times. The typical spread is about three points, and the current spread is still over 10 points. We think there's been a great distortion in terms of valuation across stocks.

The inflation dynamic is driving a rebalance back to more normal levels, especially as inflation is better for value stocks. They tend to be more ‘materials-type’ businesses, with pricing power when demand for goods is strong, supply is restricted and even with ESG pressures. We think this will play out over 10 years.

GH: Do you think the market has missed a big theme that is undervalued or under-appreciated?

RB: The strongest when we look at the stocks that we own that we think are undervalued is what we call ‘ESG inflation’ and the clear path needed to reach net zero and reduce carbon exposures. It creates a supply reduction in some parts of the economy but also the amount that needs to be spent to achieve net zero is over US$3 trillion a year over the next 30 years. Whereas we used to fund the world economy on about $500 million a year of fossil fuel investment. We need to create a new fleet of energy generation rather than use aged equipment, with the capital intensity of renewables higher dollar per unit of generation than traditional sources across a range of fossil fuels.

It includes different types of fuels, commodities, construction requirements, engineering skills and the like. A name we really like is Worley (ASX:WOR), not only do they service traditional oil and gas companies, but also the engineering required for large-scale renewable projects such as carbon capture or offshore wind projects. Already, 30% of their order book is in the renewable space and we expect that to grow strongly.

GH: It’s easy to be a fan of resource stocks at the moment but they have a boom-and-bust reputation including in the

good times, not spending capital well. How do you feel about resources?

RB: We've been overweight in Woodside (ASX:WPL) and Worley, leveraged to the energy cycle, but we're underweight iron ore. There's been a shortage of iron ore and strong demand out of China but that's changing and the long-term price for iron ore looks a lot lower than where it is today. We like to buy the names that are unpopular, but right now, it's hard to find a commodity that is not trading well above normal. We owned South32 (ASX:S32) and did well out of it.

GH: Can we turn to identifying something which has not gone well in your portfolio, perhaps a stock you strongly believed in but eventually, you decided to sell because the thesis didn't play out? What did it tell you about your investment process?

RB: Yes, QBE (ASX:QBE) has been difficult for us. We avoided it for so long from about 2000 when it was an extremely strong stock and they had some management changes. It was hit by the commercial pricing cycle and it came back a long way, and it was looking attractive to us. New management was in place, building trust and we took a long time to build faith in the new management. Then COVID came along and they had greater losses from credit insurance than we expected and then they did a rights issue. We thought we had taken the time to understand it but there were further management issues. The lesson is that in many opaque types of companies such as insurance, management trust and board competency are really important. QBE is resetting itself again and the fundamentals are there, there's a new CEO and a recent profit downgrade but things look better now.

GH: And every investor has the one that got away, the one that you were looking at but maybe it didn't meet your price target. Is there a company that has done a lot better than you expected?

RB: In recent times, it's the copper names. We were very positive on the demand side but found copper stocks expensive for a long time. Then in March and April 2020, there was a great opportunity to get those copper exposures at a good price and we missed that one. There was so much happening but we didn't buy into it at the right price and it got away from us.

GH: And on the positive side, something you own that has delighted you?

RB: We have owned JB Hi-Fi (ASX:JBH) for so many years and thought it was a quality retailer, a great brand proposition, best in class and yet it always traded as a consumer cyclical. Most people didn't have much faith in it, and it traded at low multiples and sold off every time a problem hit the economy. But what they achieved and executed especially during COVID led to a rerating and we did remarkably well out of it, we owned about 8% of the company at one point.

GH: Last question, what do you think are the key requirements of a fund manager?

RB: The importance of team and investment process. It's a complex, uncertain world and the benchmark has lots of names in it. You need a disciplined investment process with experienced analysts and investors on the same page in what they are looking for. You need to capture people's insights in the art of investing and getting that blend right takes time.

Reece Birtles is Chief Investment Officer at [Martin Currie Australia](), a Franklin Templeton specialist investment manager. Franklin Templeton is a sponsor of Firstlinks.

Ned Bell, Bell Asset Management: The generational step change underway

11 May 2022

During market dislocation events, investors react irrationally and it should be a great environment for active management. The last few years have been an easy ride on tech stocks but it's now all about quality.

Ned Bell is *Chief Investment Officer and Portfolio Manager at Bell Asset Management, a global partner of Channel Capital.*

GH: The Bell Global Equities Fund was launched in 2007, that's 15 years ago, and you were recently awarded the Undiscovered Manager award in the 2022 Morningstar Fund Manager of the Year awards. What's been happening?

NB: We've been managing institutional money, building the team and focussing on distribution via platforms and advisers with more retail exposure recently. We believe company quality drives share prices but markets have not always rewarded fundamental analysis in recent years.

GH: How have markets changed in the last 15 years?

NB: Passive investing has had a massive impact, especially in the way they buy more as the market rises. Both active and passive buyers of the large FAANG stocks created an almost corkscrew impact pushing up the market. This is unravelling as we speak, and we are seeing very sharp drawdowns in massive companies like Netflix and Meta.

So the market composition has changed a lot but there's also been a generational shift. When markets are so good for so long, and many of the more experienced participants have retired, they are replaced by younger participants, whether investors or investment consultants, and many have never seen a falling market. It's a different dynamic.

GH: The market delivers surprises every year, but are you seeing something more significant now, a sort of generational step change?

NB: I am. If you think about the environment, what's on the whiteboard for this year … the highest inflation since the 70s, a raging war in Europe, a rapidly decelerating China which has accounted for a large proportion of global GDP growth in the last 10 years. The gap between GDP growth expectations for emerging markets (EM) versus developed markets has shrunk to the smallest in 20 years plus. It's a monumental turning point. Investors in EM markets must ask themselves, if the whole reason for being there in the first place is to capture a growth premium and it's no longer there, then why are we still there?

GH: Yes, and EM is one of those markets that is always about to happen, but it never quite delivers.

NB: Yes, but no matter what markets you invest in, it comes down to the companies. And in EM, we've not seen the earnings growth in the companies over 10 years. The phenomenal GDP growth is disconnected from the earnings growth of locally-domiciled companies, yet we've seen the likes of Apple and LVMH and countless terrifically-managed global companies prosper from a revenue perspective.

GH: Your emerging companies fund invests in the global small and mid (SMID) cap space in a universe of thousands of companies. How do you filter that vast choice?

NB: The first point is we're only investing in developed markets and companies with a minimum market cap of US$1 billion. We screen for a return on equity above 15% for three consecutive years and that gives us about 700 names as a starting point. After some bottom up fundamental analysis, we end up with around 150 names in this SMID sector, then it's a matter of the right price.

GH: Running an investment business from Australia, do you have good access to talk to the CEOs and management of those companies?

NB: We absolutely do. I start every meeting saying I'm not a hedge fund and that usually gets an extra 10 minutes. The fact that we are long-term shareholders endears us to them, we're not trading them, our average holding period is well over five years. In a normal year, we do 500 research engagements a year and this is our 20th year.

GH: I heard you speak recently about looking for companies with earnings resilience, but to what extent do major macro themes play into your investment decisions and that resilience?

NB: It does play into how we define quality. We look for great management, strong business franchises, consistently high levels of profitability, balance sheet strength, sound ESG principles. But also strong business drivers, and that's when macro comes in. Our investment meetings at the moment are dominated by the effects of inflation plus China and supply chain disruptions.

GH: Are there a couple of examples of companies in your portfolios with strong pricing power that can be resilient in the face of this inflation?

NB: Sure. Among the large cap names, the luxury goods are hard to go past, LVMH and Hermes, which have phenomenal pricing power and exposure to an economically insensitive market …

GH: … the more expensive a handbag, the more desirable it becomes.

NB: Exactly, and that's a good spot to be in. Companies like Moody's and S&P, terrific businesses and essentially service providers but not subject to inflation such as rising labour costs. Costco is a brilliant retailer with pricing power. In the small and mid cap side, someone like Poolcorp, the biggest pool company in the US, has no problems putting up prices. And Estee Lauder in the consumer space. There are lots of great companies to own at the right price.

GH: How do you feel about the tech stocks that seem to be forming two tiers, with names like Microsoft and Apple in the top tier and Netflix and Zoom without the same quality?

NB: We are underweight the big FAANG stocks by about 8% versus the index, and that hurt a lot until about September last year. We do have exposure to the likes of Alphabet and Amazon and Microsoft but not Apple although we owned it for about 16 years from when the first iPhone came out. We sold that due to its stretched valuation in 2020. Those first three are terrific businesses with longevity but growth is slowing. Stocks like Meta and Netflix on high multiples of 50 in growth manager portfolios can quickly derate and the prices keep falling because the value managers are waiting at 18 times earnings. Rising interest rates means one thing … multiples compress.

GH: Do you feel there are pocket of stocks, either expensive or cheap, where your team has noticed something that the market is completely missed?

NB: Yes, absolutely. I always make this point, but the global small and mid cap universe is extraordinarily inexpensive for an asset class that's consistently added value over 20 years. It's less risky than emerging markets as an asset class and the fundamentals are better. They didn't keep up in the so-called 'growth rally' until September last year, and the valuation differential is huge. If you compare the SMID MSCI index with the World Growth MSCI index, it's a 40% discount. Just buying the index is 17 times earnings versus 27.

GH: Where is it historically?

NB: It's the biggest discount in 10 years, historically, SMID has traded at a premium to large cap value. Why is this? Through COVID, many companies had to tighten their belts quickly, and smaller companies were efficient and fast and more nimble, with a lot of family ownership. They took a lot of costs out of their businesses. The earnings estimates for this year versus 2019 pre-COVID for the SMID index are 70% higher, yet prices are only marginally up. The value for money is exceptional in businesses you can own for 10 to 15 years.

GH: Every fund manager has its winners and losers. Is there a stock that you've sold recently that didn't do well and it taught you something about your investment process that caused a rethink?

NB: Yes, a Danish company called Ambu, a leader in medtech equipment, and it had been one of our better performers. We sold some when the thesis was moderating, growth was slowing, change of management, but we should have sold the whole position. The lesson is that when the thesis changes, you need to take a really hard look at it and we should have done better.

GH: Your portfolios are unhedged. Do you have any advice for how an Australian investor should think about the currency?

NB: The main point is there's a degree of inbuilt currency hedging in the portfolio. If we're buying US dollars to buy Nike, then their revenue exposure is very diverse across currencies. In fact, if you invest in a hedged product, you may be inadvertently taking more of a currency view.

GH: Are you considering a listed version of your funds, particularly with the development of Active ETFs?

NB: Not immediately but it's not out of the question. At the moment, we're working diligently on getting the funds onto platforms. We don't want to go down the LIC path which is fraught with danger and can be a distraction from what we should be spending time on.

GH: What's your pitch for active over index in your sector?

NB: The environment we're going into now will be brilliant for active management, the best for 20 years. If you think about capturing alpha (outperforming the market), it's when we see these market dislocation events, we see irrational behaviour by investors who are not used to the environment. That's what bottom-up stock pickers want. In the last five years, our disciplines of only investing in quality companies and not paying too much has done us no favours. Ironically, this is when many super funds have moved more to passive.

The last five years have been upside-upside-upside … now let's see who can manage the downside risk. Investors have become frustrated by active managers but this environment will suit skilled stock picking and portfolio construction.

GH: You're making the case for a particular type of active management, because some active managers have backed the growth story of the last five years and done well, although they've given a lot back in the last six months. Sounds like you expect league table positions to change a lot.

NB: Yes, but it's about quality. History demonstrates that quality does well in inflationary environments. There's still a lot of valuation risk in the growth end of the market and lot of poor companies at the value end. In an economic slowdown with inflation, you want to own companies where earnings are dictated by the quality of their franchise, not the direction of the economy.

Ned Bell is Chief Investment Officer and Portfolio Manager at Bell Asset Management, a Channel Capital partner. Channel Capital is a sponsor of Firstlinks.

Stephen Hayes, First Sentier Investors : How global real estate is changing

4 May 2022

Property funds are not only offices and malls. Australia is at the forefront of sophisticated warehousing but lags on build-to-rent. What about logistics, technology hubs, data centres, self-storage and health care?

Stephen Hayes is the Global Head of Real Estate Securities at First Sentier Investors.

GH: A few years ago, you wrote an article called 'The Evolution of Our Cities'. Has COVID changed what you expected then?

SH: There's an extra theme arising out of the pandemic and still evolving around decentralisation. CBD-based tenants and many service-based tenants are adopting flexible work practices as standard HR policies and that's given employees much greater control over where they live. It values more of a lifestyle decision, whereas previously, the workplace location played heavily into where people chose to live.

There are many ramifications. From a commerce perspective, there's no overall change in total but it's moved from centralised, densely populated areas out to suburban locations. Over time, we expect to see more leisure and service activities appearing in town centres within each major suburb. From a real estate and infrastructure perspective, that means a lot. Land values have risen in suburban locations, not only across Australia but almost all major cities globally. The theme is the same and inflation has been rampant. It will take pressure off toll roads with less commuting, which is very inefficient, and there are lifestyle benefits as well. Employees can manage their time better.

GH: If a business moves to a hybrid work environment, do they still need the same amount of office space? And it looks like coffee shops and restaurants in the city are still quieter.

SH: It's part of this decentralisation theme, and yes, retail in the CBD is disrupted. On the office tenancy question, it's yet to be properly tested because in Australia, the average larger corporate lease is around seven years so there are gradual maturities coming up. Accommodation requirements are assessed towards lease expiry so any changes will be progressive. But yes, absolutely, they will require less office space.

There are a couple of themes within the office market. One, there is a flight to quality, especially towards carbon-efficient and energy-efficient buildings. Things like touchless entry and a wide range of new technologies with that go with new buildings, but they're expensive as well, so tenants have to be able to pay for them. I don't think that theme will be strong enough to prevent the overall disruption of CBD office space for an extended period of time. It's not the death of the office building but there will be less natural demand. Vacancy rates will rise, rents will fall over time, including the retail services at the bottom of the towers as well. The building's use may change, for example, towards education instead of corporate.

GH: You manage global portfolios, do you see any global trends which are not yet playing out fully in Australia?

SH: In many other countries, younger generations are adopting rental over home ownership. Historically, we have valued the Great Australian Dream, young people with a pattern of settling down in employment and entering into an extraordinarily large loan for up to 30 years. We are generally indebted to an institution for that time and at the end of a working life, the home is the largest asset.

Younger generations don't trust banks, they're quite financially savvy and it doesn't make sense to have all their wealth tied up in a single asset like that. And now, the build-to-rent product from institutionally owned and managed apartment buildings built purely for rent is absolutely compelling. That's not only from an affordability perspective, but for lifestyle, a typical house or rented apartment cannot compete with these buildings.

GH: Why's that? What makes them different?

SH: You enter the building using your phone, you enter your apartment using your phone, you arrange the lease on your phone, you pay your rent on your phone, if you want to. You contact maintenance to fix your leaky tap on your phone, if you want to move apartments, you use your phone, if you want to book the yoga room, or some office space, or the media room, or a car from the carpool or a bike … you get the picture. Younger people are growing up with these conveniences and technologies and it's an easy decision for them to enter this sort of product offering.

And here's what Australians don't yet appreciate. Firstly, it is in the interest of the institutional owner to maintain the occupancy. A renter leaving is very bad because then there's downtime that hits the operating margin. So they offer a holistic product that encourages renters to stay, and that includes affordability. There is a symbiotic relationship between the owner and the customer. The other thing is – and this applies in Australia such as the Mirvac development

of 215 apartments at Homebush called Indigo – the tenants can enter a lease for as long as they like. Indigo is let to 98% occupancy and most have adopted a 12-month lease, but tenants always have the option to stay. It gives the certainty and security, like home ownership, without the big upfront payment and an enormous loan for a long time. Australia has been really slow to adopt this.

GH: Other than the Great Australian Dream, any other reasons for that?

SH: State land taxes don't favour it. If you think about an SMSF that owns an apartment – and that product will be heavily disrupted – if there are 100 apartments in the building, one apartment might incur 1/100th of the land tax liability. But each owner has access to the land tax threshold (currently $822,000 in NSW) so probably pays no land tax. Whereas if you own the whole building, you incur 100% of the land tax. The states are onboard in building more of this product with a 50% land tax exemption until 2040.

GH: Australia is part of the global ecommerce and industrial warehouse boom, which has benefitted the likes of Goodman and Charter Hall. Has this still got room to grow?

SH: This is early days. The first iPhone was launched in 2007 and we're only 15 years into it. This will run for decades and decades. Cities are messy, dishevelled places, they're not well organised, they were never expected to have such large populations with all the conveniences we have today. It will take decades to modernise supply chains. Procurement centres or logistical warehousing are nothing like they were 20 or 30 years ago, when they were glorified tin sheds. Now, these buildings are modern and full of technology. Some of the fit outs cost upwards of $500 million and they are integral to the future of society and cities.

Whenever we click on our phones, a lot happens behind the scenes, and much of it is inefficient. The tenant demand for modern logistical warehousing is the highest I've seen in my entire career. If companies don't want to compete only on price, they must get it out of the door the fastest.

GH: You divide your portfolios into categories such as retail, office, industrial and specialised. How has the mix changed and what do you expect over the next three years?

SH: There's a misconception that real estate portfolios contain a lot of 'old world' traditional-type assets such as tall office buildings and shopping malls. From a global perspective, those assets make up only a fraction of the real estate types by market capitalisation. The majority of real estate is in the new world, the modern economy where capital is going to not from. Residential is a large component, especially the apartment side. We have the widespread adoption of technology, logistical warehouses, technology hubs, data centres are an integral part of the whole internet usage and streaming services, self-storage. Health care is massive with everything from acute care private hospitals to outpatient facilities, specialised rehabilitation facilities, seniors housing, skilled nursing facilities. The amount of capital going in is immense. Science and research and demand for laboratory space is off the charts, driven by the pandemic. There are a lot of opportunities.

GH: You recently launched a new fund with a carbon reduction focus, how will that work?

SH: Responsible investing has been fully ingrained into our investment process for a decade, so this isn't new for us. We've been able to collect data properly now to benchmark the real estate sector, including the carbon associated with developments. It's around 40% of man-made greenhouse gases, so it is a massive emitter. We're invested in some of the largest landlords in the world and they're sophisticated and we've been engaging with them on the carbon side. The reporting coming out of the publicly-traded markets for real estate only tells part of the picture on carbon. We want a full picture so every stock within our portfolio includes a complete carbon analysis. We take it to the landlords and say this is where you're behind.

GH: We know about solar and recycling, but do you have a couple of quick examples of how buildings are reducing the use of carbon?

SH: One that doesn't get a lot of airtime and can't really be retrofitted is geothermal, using the earth's core temperature to maintain the ambient temperature. In most building, temperature control is a major use of carbon, the heating, ventilation and air conditioning (HVAC) systems.

GH: How does that work, do they drill hundreds of metres into the earth's core?

SH: Not that far down. It's a range of tiny pipes sitting underground pumping air from the building into the core and it either warms or heats and takes workload off the HVAC systems. We have a mixed-use (office and retail) investment in Toronto where they are excavating deep into the ground and building massive wells that will contain water from the lake to circulate through the building to maintain the ambient temperature. It's so large they will be able to cater to a range of nearby city blocks.

GH: Do you own something now that you expect you still own 10 years from now?

SH: Most of our portfolio. The only component we probably won't own is around 5% of the portfolio in hotels and resorts. They are more cyclical and starting to return to normal so we're looking for valuations that appeal. Everything else we invest in as a long-term owner based on strong fundamentals and thematics.

GH: You have global opportunities, but do you like any Australian stocks in particular?

SH: We spoke about logistics and the Goodman group is a global leader in the development of modern warehousing for long-term ownership. They also have a partnership model where they joint venture and a lot of superannuation funds and sovereign wealth funds invest with them. The high quality of their portfolio with targeted cities, high barriers to entry, land is scarce, they are experts at building. In Hong Kong, they have multi-level warehousing, five or six levels, and they're in Japan, London, Paris, California, New Jersey. And their portfolio is 98% occupied, dividends have grown 6% compound over the last 10 years, earnings growth that we're forecasting for 2022 is over 20%, with earnings up since the start of a pandemic by over 40%.

GH: How do you manage a global portfolio from Australia and gain the local knowledge of conditions in other countries?

SH: Yes, real estate's very localised in nature, they are fixed assets, you can't pick them up and put them in another market. Each asset is different based on local fundamentals. So we've got a team of 10 located in Sydney, London and New York, in the different time zones. We've been together a long time and our track record speaks for itself.

GH: I must finish by asking you about sensitivity of real estate to inflation and rising rates.

SH: Central banks have been very accommodating with ultra-loose monetary policy, and as we all know, that's changing. But even with some rate rises, from an historical perspective, rates are still very low. There is a long way to go before money supply is constrained but central banks must act to control inflation. So in real estate and financial markets generally, the required returns will rise over time. If you're invested where the real return is not high enough, you will get impacted. But if you're in the new economy, a beneficiary of these societal change, with low unemployment rates and healthy household finances, many will benefit and that's where we believe we're invested.

Stephen Hayes is Head of Real Estate Securities at First Sentier Investors (Australia), previously Colonial First State Global Asset Management and a sponsor of Firstlinks.

Arian Neiron, VanEck Australia: 30 ETFs in one ecosystem but is there a favourite?

13 April 2022

In the last decade, ETFs have become a mainstay of many portfolios, with broad market access to most asset types, as well as a wide array of sectors and themes. Is there a favourite of a CEO who oversees 30 funds?

Arian Neiron is the Chief Executive and Managing Director for VanEck Australia and Head of Asia Pacific. VanEck is an Exchange Traded Fund (ETF) issuer with 30 trusts worth over $10 billion listed on the ASX covering broad markets, sectors and thematics.

GH: In nine years since starting VanEck in Australia in 2013, you've launched 30 ETFs. How do you decide what's next?

AN: In the ETF industry, it seems like there's a new idea every second Monday. Some funds are common sense and some are a bit spicier or esoteric. We want to create an ecosystem, or a range of strategies within a portfolio. We always go back to our guiding principle, our *raison d'etre.*

It's about democratising investing and ETFs are a fantastic platform. It's about accessing the opportunities and we think about how the world is changing, such as geopolitical, structural or societal. And that presents a range of different opportunities reflected in asset prices.

We also leverage off the capabilities of the Australian team. We all come from active management backgrounds, plus the global firm was set up in 1955, so we also leverage off the franchise globally. If there's a new idea, we stress test it, we look at modern finance theory, we speak to academics, we look at any empirical research, and we do our own research. We might speak to different index providers, or we partner with active managers. We think about what will withstand the test of time and it might take three to five years to process all these inputs.

GH: You've avoided the traditional cap-weighted indexes in favour of other types of indexes. For example, your Australian broad market index is based on an equal-weighted index. Why have you gone down that path?

AN: Two things. Number one, it's beyond the usual approach of the standard ASX200, we have the Australian Equal

Weight ETF (MVW) that equally weights the most liquid securities on the ASX. We're not trying to be simple market beta, and this is really the genesis of the firm. The second part is a by-product of the Australian leadership team and the firm's history with John van Eck. Active management is infused in the DNA of the business and that intellectual capital has been transposed into the ETF side. We are more of a smart beta pioneer.

We think if there's a genuine investing edge in active management then we look for a systematic, rules-based way. We look for identifiable alpha or persistent drivers of return, ensuring funds in our entire ecosystem are complementing each other. So, in international equities, we launched international quality (QUAL). In the small cap space, we went for international small and mid-caps (QSML) with a far bigger opportunity than Australian small caps. These are all different approaches to align with how we think about managing money for the long term.

GH: After launching 30 funds, have any of them done much better than you expected?

AN: It's always a pleasant surprise when a fund does well. One that's done better than expected is our bank ETF. My parents and in-laws have owned banks since the 1990s and they have done well with dividends and franking credits, but our Australian bank ETF (MVB) has been a pleasant surprise. People were saying the banks are all correlated but one is more into residential mortgages, another in SME lending, so is it 'much of a muchness'? The bank product has helped people to top up and the fund now has over $200 million doing exactly what it should do. Dividends and franking credits seem kind of vanilla boring, but boring can be really good.

GH: And what has done worse than you expected.

AN: The word 'worse' is harsh but what hasn't met expectations on gathering assets is in emerging markets, our broad-based fund (EMKT). It's a multi-factor approach and it looks at four persistent drivers of return (small companies, momentum, quality and value) and it combines them all. It holds about $50 million but why I'm disappointed is it is the number one by percentile across all periods against active managers in its sector with about 9% alpha for the year. We're charging only 69 basis points (0.69%) when the market beta is 0.65%p.a. I think in Australia, there's no active manager incumbency but emerging markets is not an arena where people are strategically allocating, it's more of a 5% at best.

GH: I think that's a widespread emerging markets experience, it's a sector not in most portfolios. You have a range of thematic and sector ETS. Do you find that inflows and outflows go hot and cold depending on the news or the macro events of the day?

AN: I like to split thematics and sectors, they are quite different. On the sector side, infrastructure, property, even global health care, they have defensive earnings. Thematics is covering a large universe with a lot of market participants.

Australian ETFs are still in an embryonic stage at around $130 billion and it's really been a one-way street and flows have been more in than they have been out. But has the money really followed the momentum or the hot money for these thematic ideas? Some thematics in the market are flavour-of -the-month and returns look phenomenal for a year but it's often profitless technology and then gravity hits as we have a reversion to the mean. We've not really experienced this because we don't proliferate a lot of thematics going from hot to cold.

In our space, we've got clean energy (CLNE) and video gaming and esports (ESPO) but we look at it more as structural trends. We do tend to see flows when there's momentum and strategies are performing well as investors chase historical returns as opposed to assessing fundamentals. When prices come off, it definitely puts the brakes on money coming in.

GH: We recently finished the first quarter of 2022, where did you have the biggest inflows and outflows?

AN: Investors are contending with a lot of geopolitical hurdles. Our best flows are in international quality, QUAL, the flight to quality is very strong. Also, our A-REITS (MVA) and global infrastructure (IFRA) have done well. A-REITS was a surprise and I think investors are still looking for income perhaps with a view that the 10-year bond has peaked and property responded favourably to that.

GH: And the other side of the ledger.

AN: A real surprise to me since VanEck is the biggest gold equity ETF issuer in the world and gold has risen strongly this year, we've had a bit of money come off the table in our gold miner EFT (GDX), especially since gold is seen as a hedge for inflation.

GH: With the majority of 2022 still to go, if you picked two of your funds that will do best over this calendar year, what would you forecast?

AN: I'm a big believer in diversification and people only talk about their good investments and not the ones that failed. But if I had to pick two from our suite, I would say gold equities (GDX) is well positioned given concerns in capital markets around valuations in a stagflation period, especially in a new inflation regime. Investors get operational leverage with gold companies, sustainable costs are low relative to the gold bullion price and balance sheets are clean. And if you look at simple ratios such as the price of gold companies relative to bullion, they are at record lows.

The second one is global infrastructure (IFRA). With aging utilities around the world and an estimated $60 trillion needed to spend by 2035, particularly in the US. Investors receive good, stable income streams, often regulated and CPI-linked with more compelling valuations than other securities. The more defensive nature over the long term with diversification should bode well for investors.

GH: And with 30 babies that you've given birth to, do you have a personal favourite, perhaps one that you're confident if you invested today, you'd probably still hold it 10 years from now?

AN: That's like asking about your favourite child and you can't choose. One that's really my baby as it extends on my career is our equal weighting, MVW. A lot of my training was at Perpetual which is a strong fiduciary and fund manager. If you look at the ASX200, BHP is 11% to 12% concentration now, compounded by the cyclicality of the market. The Australian market is too concentrated across stocks and sectors, so we targeted liquidity and in large caps, there's better price discovery than in small caps. I'm quite optimistic about Australian equities and I don't think we have the inflation conundrum that the US has. MVW also has good exposure to some great companies in the mid-cap space without moving too far away from the large caps.

GH: Can you give us some hints about what funds are in the pipeline?

AN: We're always working on a few ideas but I'll give you a bit of a teaser, it's around the climate change megatrend and how to access that. And we're looking at Bitcoin and Ether and cryptocurrency which creates a quite vicious debate, even internally, because we come from a more traditional asset management background. But we do think digital assets and decentralised finance done in a more regulated structure such as an ETF with market makers supporting it is a more appropriate way to do it.

Also, a lot of active managers have come to us to partner and we're looking at some long-standing and sustainable investment strategies, but nothing yet where I can really get down into the detail.

For me, the key question or consideration for investors with ETFs is while it's very exciting, always look under the bonnet like test driving a car, ask advice and know what you're getting into.

Arian Neiron is CEO and Managing Director - Asia Pacific at VanEck, a sponsor of Firstlinks.

Roger Morley, MFS Investment Management: The merit of obstinacy in global investing

16 March 2022

What does a global investor think of the consequences of war, changing investment opportunities, building portfolios, good and bad stocks and why obstinacy amid short-term trends is a positive attribute?

Roger Morley is a Portfolio Manager with MFS Investment Management in London. He is Co-manager of the firm's Global Equity and Global Concentrated Strategies and lead manager of the European Core Equity strategy. He has been with MFS for about 20 years. Globally, MFS manages almost $A1 trillion across all asset classes, with headquarters in Boston, USA.

GH: As a global equity manager with offices around the world, what do you consider some of the major investment implications of the war in Ukraine for either the near term or longer term?

RM: To start, we must say the humanitarian and social costs are terrible. From an investment point of view, there are implications for individual businesses, but in aggregate, it's not such a big deal for the global economy with one major exception. Russia is about 1.5% of global GDP, similar to Canada's. The Russian economy is not particularly integrated into global trade, again, with one big exception, which I'll come to.

We like multinational businesses and we typically like businesses that operate in emerging markets because there's good growth there. But for our typical business, Russia is 1 to 3% of sales, such as for AkzoNobel (paints and coatings), WPP (advertising agency), Nestle, Linde (industrial gases). There will be some surprises, such as Visa, MasterCard and American Express. Russia and Ukraine together represent about 5% of revenues for Visa, one of our biggest holdings. That's because Russians travel and spend a lot on cards and cross border business is more profitable than domestic business. But even that shows Russia is not a major part of the world economy. We own

Carlsberg, which has about 15% of its business in Russia and Ukraine.

The one caveat is the Russian supply of raw materials, principally energy. It's one of the world's largest oil exporters and a huge exporter of natural gas to Europe. Natural gas is 25% of European energy consumption and 40% comes from Russia, of which a vast majority goes to Germany and Italy. So the company level modest exposure exception is where companies are particularly exposed to high energy and raw material prices.

A few companies will be clear beneficiaries. We met at a couple of US defense companies last week, talking about the low state of preparation of many European militaries and the need to increase resources. It's a medium-term benefit because it takes a long time to ramp up the manufacture of missiles, engines, fighter planes.

GH: I was surprised when I saw a map of Europe on the gas pipelines coming from Russia through Ukraine, with an extraordinary level of dependence. Is there a feeling now among European governments that the dependence was too complacent?

RM: Very much so, especially in Germany. There was a lot of controversy over the building of the Nord Stream 2, which was supposed to reduce the reliance on the pipelines that went through Ukraine. Russia could then turn off the gas to Ukraine without turning off the gas to Germany because they pay the bills.

GH: Let's look at some broader portfolio matters. To what extent do macro factors influence your investment decisions? For example, if you had a chemical company in Europe and another in the US, do you consider whether the economy in the US is better than Europe for the next few years?

RM: Through our global investment platform, we uncover what we believe are the best investment opportunities in the market. We are looking for an analytical advantage by evaluating the long-term quality, sustainability, improvement potential and value of businesses. It's fundamentally bottom up, research driven. We invest in businesses, not markets, we invest in companies, not stocks. You can't escape the macro but we focus on understanding the business and on the equity side, we have 60 research analysts based around the world. They tend to follow companies on a regional basis so we do compare stocks across a region, but then the global managers sit above that and it's easy to pull the analysts together to compare ideas and get the best on a risk-adjusted basis globally. Internally, we never talk about regional overweight and underweight. We don't care where a company's headquartered or listed with the single exception of governance, as there are different country regulations.

GH: You manage a concentrated portfolio as well as a broader global equity portfolio. What's the difference?

RM: It's the same team-based approach, with Ryan McAllister and I co-managing both portfolios. We run them in parallel, but the concentrated one holds between 20 and 30 stocks as a subset of the diversified portfolio which is usually between 80 and 100 stocks. We pick what we consider the best names on a risk-adjusted basis. Sometimes, I think people confuse concentration with aggression, but the stocks we pick are a little more conservative because we own a bigger position. So we may have a stock in the diversified portfolio where there's a wider range of outcomes that we think is a good stock on a risk-adjusted basis, but there could be a lot of potential downside because of technological change or balance sheet leverage or political exposure or regulatory exposure, something like that. We can limit that downside with position sizing, but in a concentrated portfolio, we own 2.5% minimum and the average position size is 4%. So a company like that doesn't go into the concentrated portfolio. It's not aggressive investing in that way because we worry especially about the downside in the concentrated portfolio.

GH: And how's the relative performance of the two funds over time?

RM: Over the long term, the concentrated portfolio has marginally outperformed. In a way, I find that slightly annoying because a constraint on a portfolio manager should detract from performance. I think there are a couple of explanations. One is that we're better at managing a concentrated portfolio than a diversified one. By being forced to have conviction, you get the better ideas. In times like these, it can be difficult to differentiate between active skill versus the market environment, but it reinforces the importance of security selection by focusing on quality growth companies and considering all risks.

GH: In your current valuations of companies, are you seeing pockets of expensive or cheap? In other words, where are you seeing the best opportunities?

RM: In the areas that we think are cheap, I'd call out medical devices in particular and healthcare in general. We own large positions in stocks like Medtronic, Stryker, Abbott. A company like Medtronic is still somewhat depressed because a portion of its business is elective surgery. Many elective procedures have been postponed in the last two years, clearing the decks for COVID. The recovery of these businesses has been slow because staff are off work and isolating. They weren't defensive stocks in the downturn because of their exposure to the realignment of the healthcare system but they look inexpensive.

Another area is US cable companies, such as Comcast and Liberty Broadband. We all know how vital a fixed broadband

connection is, and those businesses are increasingly not pay TV companies. They are broadband and telecommunication providers. There's always fear of technological change, whether it's Elon Musk sticking satellites up or 5G wireless broadband but fixed broadband connections are not going away anytime soon for the vast majority of consumers.

GH: And on the expensive side?

RM: I would still call out some technology stocks even after they've been de-rated, the ones with no profits and no clear path to a free cash flow. There are some remarkable businesses in the technology space that we would happily own at lower valuations.

GH: Is there a stock you would identify that you think has such a good long-term runway, a compounder that you're confident you will own for the next 10 years?

RM: I probably call out a railroad stock, Canadian National or Canadian Pacific. Perhaps not the world's most exciting companies, but it's the 10-year picture that's important. Canadian National has been known to us for over 25 years. Railroads face relatively little technological change, they are pieces of infrastructure that are vital to the North American economy. They are very hard and very expensive to replicate. They are oligopolistic and probably monopolistic. We love monopolies from an investing point of view. We don't like monopolies from a regulatory point of view, so I'd rather call them oligopolistic, but they have monopolistic qualities. They've got tailwinds from the ESG side with a much lower carbon footprint to move something around North America than by road. Vastly better than air freight or other alternatives.

Canadian National will grow at GDP plus with a bit of pricing on top of volume growth and operating leverage from the vast fixed cost base. It's still a capital-intensive business so it's hard to see any form of disruption coming. We don't really worry about driverless trucks that may dramatically change the economics of rail versus road transport. That floats out there in the far distance. From the economic cycle, volumes tend to vary a little but pricing doesn't.

GH: Is there an investment lesson that you've learned recently, despite all your years in the business, due to a stock that didn't work out and perhaps you sold it? Perhaps something you missed?

RM: In this job, you think by the time we retire, we'll be geniuses because you make mistakes and you say, "Well, I won't do that again." And then a mistake is around the corner and sometimes you repeat a mistake because the situation looks different. A quality we have is that we're very long term, we're pretty obstinate. That the market overreacts on the downside, it overreacts to fears of disruption and change and usually that disruption and change is less than anticipated.

But sometimes we're slow to spot that an investment case is just wrong. For example, for many years we owned the US trust banks, State Street and Bank of New York. Our view was that these trust businesses would discover pricing power but that just hasn't been the case. And what's annoying is that I had people tell me that their prices only ever go down. I talked to people internally at MFS and they said prices always go down when we renew our contract. And why, I don't know. The business is just competitive enough, there are just enough players in it. So that's a case where we ignored the fundamental evidence that was before our eyes or we didn't look for it properly.

They weren't terrible stocks, they did all right, but they were always relatively cheap so that limited the downside. But if you own stocks like that for a long time, they become a big hole in your attribution over time. It's the grinding underperformance where we've been too dogmatic in hanging on to them.

GH: Final question. You've done this job for a long time. What's the attraction?

RM: It's fascinating, particularly at a time like this, when so much is going on in the world. As a portfolio manager at a firm like MFS, you're like a fly on the wall of the world. You get to meet people like the CEO of a supplier of Stinger missiles and anti-tank missiles. A month ago, we met with a former security adviser to Donald Trump. He said the prospect of a war in Ukraine was 80% and it will probably happen. Very hawkish. It was a striking contrast between his certainty and others being generally laid back. It's the access to people that makes the job so fascinating.

Roger Morley is a Portfolio Manager with at [MFS Investment Management](), a sponsor of Firstlinks.

Vic Jokovic, Cboe Australia: What does new global ASX rival mean for your investing?

9 March 2022

Global exchange and derivatives company, Cboe, recently acquired the local ASX competitor, Chi-X. Its CEO explains what global capabilities it brings and why you may already trade through Cboe without knowing it.

Vic Jokovic is Chief Executive of Cboe Australia, which recently acquired the Chi-X Asia Pacific business with plans to fully integrate it into Cboe's global operations and technology platform. This is an edited transcript of a discussion on 2 March 2022.

GH: Can you explain the significance of Cboe acquiring Chi-X Asia Pacific, especially for the Australian market?

VJ: Cboe coming into Australia is the first time a significant global exchange has operated here. ASX might take exception to not being branded a global exchange, but Cboe has offices in 15 countries and operates in over 25 countries including, obviously, the US. Cboe stands for Chicago Board Options Exchange, but we've got large operations in New York, London, Amsterdam. Tokyo and now Sydney. And so a very large, Australian-centric exchange, the ASX, is competing with a very large global exchange group with products that the ASX doesn't have within its tool chest.

GH: Most of our readers probably assume when they trade online through CommSec or nabtrade or another broker, that the deal goes through the ASX. When does it go through Cboe and when through the ASX?

VJ: About 20% of the Australian market is now traded on Cboe Australia. Let's go a step back and begin with an investor placing an order. There's a broker responsibility to achieve the best price at the time, the best execution. Some follow it to the letter of the law, others don't. It's a little loose in terms of interpretation but it means that the broker uses smart order routers to send that order to the exchange that has the best price at that time. And we set the best price in the market approximately 35% to 40% of the time. Brokers that are not connected to both exchanges - and there are a few that aren't - can't guarantee they're delivering the best price to their clients. But it's seamless, investors don't see the mechanics. It's the broker's responsibility to route to the best price at either ASX or Cboe.

GH: If I'm an issuer or company that wants to come to the market, such as a mining company, industrial company or an ETF, what's your pitch? What's the price competition you bring versus the ASX?

VJ: The pitch prior to the Cboe acquisition was simply price, like any disruptor. Our pricing schedule is significantly lower than the incumbent, which was previously a monopoly provider. We also had the advantage of being nimble and innovative. I know everyone says that but we were focused on what we wanted to be good at, such as ETFs and warrants, trading certain types of market order to make it easier and faster for the brokers. That was our value proposition. Going forward, we have a different set of pluses. We will introduce access to global products and that gives anyone listed on our platform over time the ability to have that product access right across the globe. It's something that the ASX can't offer because it doesn't operate as the largest exchange across 18 markets in Europe, the largest derivatives exchange in the US and the third largest exchange in North America.

GH: Will Cboe have a strength or emphasis on certain types of products?

VJ: Yes. Cboe is the dominant global derivatives exchange but the Australian derivatives market is a monopoly held by the ASX at the moment. The options market has been stagnant in Australia for a long time whereas it's vibrant offshore. The ASX derives about $200 million a year of its revenues from a small number of contracts primarily across the futures side of their business, such as 3- and 10-year bonds, 90-day bank bills and recently, electricity futures. So, we will look at all of those. But for now, our focus will be on business-as-usual in trading shares and warrants - where we have 35 to 40% of the market, sometimes up to 50%. The ETF piece is obviously a key angle for us.

GH: What happened with the TRaCR product which was withdrawn recently? I liked the way investors could access great US companies directly on the local exchange. It seemed like a good idea. What's the potential for investing in global stocks through a normal Australian broker account with the FX handled automatically?

VJ: The advantage of TRaCRs was US mega caps denominated in Australian dollars in the Australian market. The product was going well with about $50 million in assets but it had taken two to three years to get there and it wasn't commercially viable for the issuer (Deutsche Bank) to continue. So, it wasn't a decision made by us and we tried

other issuers but for a bunch of reasons, it didn't happen. It's a product that we may resurrect in future with a different issuer because I think there is a place for an ADR-style (American Deposit Receipt) product around global shares in Australia and the next port of call was going to be Asian and European names.

GH: Chi-X (Cboe) is well known in Australia for its range of Active ETFs. Do you see any new asset classes or developments in that ETF space?

VJ: Yes. We were at the forefront in innovation around the active space, certainly in fixed income funds. We gain the advantage that Cboe itself has about 550 listed ETFs with all the usual issuers, the big fund managers down to some boutiques as well. We're currently talking with a few global managers that are well known plus some lesser-known Australian fund managers, to bring unique product into Australia.

GH: Such as?

VJ: Such as commodities and obviously, crypto. One of the issues is that crypto is not a regulated market, so the concept of a crypto ETF listed on an exchange via ASX or Cboe is the next step, and we are very close. We have ASIC approval to quote a Bitcoin ETF, I think it will be the first crypto ETF offered on this side of the globe.

GH: As an investor, I like the convenience of execution on an exchange and avoiding the 20-page offer document of unlisted funds, the need for a certified copy of an SMSF trust deed and all the other paperwork. I can't be bothered. Why have more fund managers not gone the listed route yet?

VJ: Good question. It's accelerated in the last 12 months and the pipeline is strong for us and the ASX. I wouldn't be surprised to see 50 to 100 new ETFs in the market over the course of the next 12 to 18 months. Our plans see us moving from our current 20+ funds to close to 100 by the end of 2023. I don't think we're flippant or aggressive in our forecasting, it's just the pipeline.

Why haven't fund managers done it before? I think it needed a few funds to lead the way and the listed space was traditionally the world of the passive index trackers. Magellan, Schroders, Janus Henderson, Perennial … they led the way. They get access to a broker market, the 'Know Your Client' and the other rigmarole is already done for these clients, so the process is easier. It's the last distribution piece that these fund managers hadn't considered, and they have seen the success of others.

GH: Especially when Listed Investment Companies have problems not being able to pay stamping fees, so unless you're someone with a special marketing capability, like Geoff Wilson, a lot of those LICs or LITs done two or three years ago wouldn't be possible now.

VJ: Yes, and we've seen conversations (of LICs to ETFs) and some dual access models.

GH: Does Cboe target a particular part of the market, such as insto, retail or advisers?

VJ: The journey has shifted. When we first started, the most important client base for a new exchange was the brokers as we call them, the large investment banks. We started fishing there 9-10 years ago when Chi-X Australia first kicked off. Then the next step was connectivity to all stockbroking firms, including in some respects global, so we have 50 to 60 trading participants sending us and ASX orders every day. These brokers control 99% of daily volumes. Then as we moved into the ETF and ETP space, we needed strong connectivity into the wealth platforms as well.

We have a higher percentage of our daily volumes and value traded coming from retail brokers than the ASX. There's a misconception that being a newer exchange, we are heavily reliant on high-frequency trading firms. That's not the case at all. The split with the ASX is similar but skewed for us to those big retail brokers.

GH: What's your strategy and communication with the financial advice industry?

VJ: It's a work in progress that's been happening over the course of the last few years. We have two salespeople that look after the retail piece and they're heavily involved with advisers.

GH: Where will the business be in three to five years?

VJ: Where do we want to be? While we compete with the ASX across two or three limbs, we don't compete in clearing and settlement, yet Cboe is a much larger clearing and settlement operator. We don't compete with the ASX in options and futures and Cboe is a much larger futures and options house. And corporate listings is the third key focus for us. They are huge projects.

The government, the RBA and ASIC are pro competition. They're supportive, particularly now that it's not a small exchange looking to compete in these areas. You know, exchanges are typically quite boring. It's hard to make an interesting story out of an exchange business but after 150 years of ASX essentially going on its own, this will mix it up a little bit.

I draw the analogy of an Aldi or whoever else coming in to compete with Coles or Woolworths or Uber shaking up the taxi industry or the telco industry after Telstra had the entire industry to itself. That's the upside. We just can't screw it up.

Vic Jokovic is Chief Executive at Cboe Australia, a sponsor of Firstlinks.

Hamish Douglass, Magellan: Last interview before medical leave

9 February 2022

Last week, I interviewed Hamish Douglass about investing and positions in his portfolio. He was articulate, confident and relaxed, but a few days later, the Board of Magellan announced he was taking medical leave.

At the Morningstar Investor Conference last Thursday, 3 February 2022, I interviewed Magellan founder, Hamish Douglass. He was relaxed and chatty before the interview, discussing the renovations to his long-time family home, his love of swimming and gym work, and he admired the surrounding developments at Barangaroo. Although one of his larger positions, Facebook (now Meta), had fallen heavily overnight, he projected a fund manager genuinely focussed on the long-term merits of companies rather than short-term price movements. Such sentiment dominated the interview.

During the discussion, I focussed more on what Hamish thought of current opportunities, how he manages Magellan portfolios, how he judged his 15 years of performance, and the coming risks. While some people in the audience no doubt wanted me to ask about his personal life, I felt there was enough revealed and responded to already in the media, and I wanted to discuss investing. He was also unlikely to reveal price sensitive information without a release to the ASX.

Three days after our chat, on Sunday, the "***intense pressure and focus***" on his personal and professional lives seemed to reach a tipping point, and he contacted the Board of Magellan to request "***a period of medical leave to prioritise his health***". The next day, the Board issued a statement to the exchange, including:

"The Magellan Board wholeheartedly supports Hamish taking the time that he requires to focus on his health and looks forward to welcoming Hamish back.

At the request of the Board, Mr Chris Mackay will oversee the portfolio management of Magellan's global equity retail funds and global equity institutional mandates ... Ms. Nikki Thomas has re-joined Magellan as a co-portfolio manager of Magellan's global equity strategies."

Here is an edited transcript of the interview, where he admits to mistakes but also explains why he considers his portfolio is right for the times.

GH: It's my pleasure to welcome Hamish Douglass, the CIO and Chairman of Magellan. Welcome to Morningstar.

HD: Graham, it's great to be with you.

GH: I'm not sure whether you remember this but about 15 years ago, you and Frank Casarotti came into Colonial First State where I was at the time, pitching a new global fund to be added to FirstChoice. And because we needed a track record, which you obviously didn't have, we initially knocked you back. 15 years and $100 billion later, a lot has happened. At that time, you were talking about delivering to your investors a 9% return through the cycle. The Global Fund has delivered about 12% since inception. So how do you think about or judge that performance?

HD: Graham, it's very interesting because I remember when we first came out with the 9% return, which was right up front. As you recall, this was in July 2007. And actually, markets had been on a roar because it was before the collapse of 2008 and people were kind of yawning at 9% per annum, saying we're not interested in anything under 20% per annum at the time, and we're going, well we just didn't think that was very realistic.

So have we been happy? You know that the strategies, it's since July 2007 and people recall markets last peaked in October 2007. So we're kind of peak to peak. The equity markets peak to peak have done about 8% per annum, measured by the MSCI World Index, and we've done about 12% per annum over that time. It doesn't sound a lot of difference, 4% per annum, but over 14 and a half years, you would have 67% more money invested with Magellan. So

the absolute return you earn over time is incredibly important.

And we've managed to do it with materially lower drawdown risk than markets and people get very caught up with this concept of relative or absolute return. We're not thinking about what the share price will do relative to the market at any point in time and frankly, I have no idea what the share price is going to largely do over the next six to 12 months.

GH: Don't worry, I wasn't going to ask you about that.

HD: But what we're trying to do is assess whether or not those earnings on that company over the next three, five to 10 years into the future will compound at a satisfactory rate and then we measure that against the 9% return. That's our focus in investing. We're not speculating, we make judgments around where the earnings of businesses go over time? And if you get that right, you can deliver very attractive absolute returns over time.

GH: When you're thinking about the portfolio, how much do you weigh up this absolute versus relative return because obviously the market and some of your clients think in relative terms and compare you to a benchmark, so you can't totally ignore that. How do you weigh that up?

HD: Yeah, at the end of the day, Graham, I've never found an individual who's retired on relative returns. Historically, the markets have been doing for the last 30 years about 8% per annum. So just investing in the market has been fine because the return in equities has been attractive, but there have been points in history where markets have delivered for 15 years, zero rates of return.

If we did let's say 2% better than the markets over a period of 15 years and the markets did zero, we would be very unhappy. And a lot of people would say that's a great result. If we don't do 9% per annum even if the markets do zero over an extended period of time, we don't think we've done our job because people don't retire at 2% per annum even if it's beaten the markets.

I would look out from here and caution people because interest rates have been falling and they've been exaggerating equity returns for 30 years. I think equity returns from markets are going to be lower than they've been in the past. Our job is to make judgment in a select collection of businesses that we think can compound people's capital to get us that 9% return per annum. If you can give people 9% per annum over the long term, that means every eight years we're doubling our clients' money. People can effectively withdraw 4% per annum and therefore have their capital still growing in real terms that they can give to the grandchildren.

But if you deliver 2% per annum and the market is zero, you're going backwards, you better lower your lifestyle expectations, you better lower what you want to leave with your children. Over the long term, our 9% per annum I actually think will beat any equity long-term benchmark measured over a long enough period of time. But in the short term, the share prices of businesses can go anywhere.

I don't really pay any reference to what Microsoft share price will do relative to an index of 1600 companies in the next six months but I have very, very high conviction over the next three, five and 10 years Microsoft will deliver a very good return for our investors but do I get caught up if Microsoft underperforms the market in the next six months? I don't even think about it.

GH: We know the market falls by 10% every few years. When that happens with your portfolio, what's your emotional reaction? Do you say, great, this is a buying opportunity or do you think, my clients have just lost $10 billion? How do you manage those big changes?

HD: If the markets drop 10%, of course, there is a mark to market apparent loss. But you only lose if you actually sell anything at that period of time. Do I worry about that? Normally I'll look at it as an opportunity. As an investor, people need to understand when they're invested in equity, the market gets quite emotional. And in the short term, it's this sort of emotional voting machine.

Two weeks ago, Netflix's share price fell 20% after its result. It's recovered its losses over a week. So you know what's happened in the last week of a rollercoaster? If you went away for a week, nothing happened. But during that week it looked like this incredible emotional experience. People need to understand that equities in the short term can be very, very volatile.

It's interesting that people's major asset is their house. Do people ask a real estate agent to value their house every single day? Depending on the mood of that real estate agent, they can tell them it's gone up 5% today and the next day they're told it's gone down 5% and then people are getting worried that their wealth is falling because their house price is going up and down.

The market's an odd thing that is throwing you a price every single day but if you think about it, what you own hasn't changed at all. You still have the same interest in those businesses with the same prospects of those future profits. But day to day they jump around in price and what I'd say to people is you're better switching it off. Equities is a long term investment game. And if you get the right collection of businesses and they compound their earnings, in the end the market's a weighing machine as Ben Graham says and the returns will look after themselves.

So when the share markets go down 5%, do I think we've lost anyone any money? No, I don't, because we still own exactly the same assets which have the same prospects the day before they fell and the day after they fell.

GH: Hamish, you're clearly a stock picker, an active stock picker, but you do make macro calls as well. You change your cash weighting accordingly. And when you speak, you obviously talk about inflation and viruses and macro things. How do you weigh up that stock picking versus the macro call because going to cash means you're out of the market to a certain extent.

HD: Well, let's put it in context. We can go up to 20% cash, so I'm always 80% invested in equities. I think we have to put any decision we make around macroeconomics in context. So we're normally above 90% invested in equities and often above 95%.

Why do we use cash and macroeconomics? It's really risk management. We're very conservative people and if we see risk out there that we think isn't priced in markets, we may for a period step back a little bit. We're taking less risk in order to preserve more capital and to give us a little bit more breathing space and firepower to take advantage if there is a sell off.

I think we've had a pretty successful record, not always but I think our batting average has been strong in making the judgment call of when to put risk on and risk off in the markets but you don't get everything 100% right. But I don't think people should worry about it that much. Because we're always going to be 80% invested in equities while we take a conservative view of looking after people's capital.

GH: As an investor, I would rather you didn't do that because if I allocate some of my portfolio to Magellan, I'm saying that's my equity allocation. That's 100% in equities, and I'll look after the risk management in the rest of my portfolio. I don't want to have to say that actually 20% of that portfolio is in cash. Obviously, you see a different position.

HD: Yeah, we do see a slightly different position at the end of the day, I think we've put an absolute return target on that. And we know if we sit in cash for an extended period of time returning nothing, that's going to make our job of getting 9% per annum harder. We absolutely understand that cash is not going to compound at 9% per annum, we're only doing it as part of our portfolio construction and risk management. We're not guaranteeing by the way the 9% but we have it as the absolute benchmark.

GH: It's tempting at any point in time to look at all the pluses and minuses in the market and heaven knows, we've got a lot of them at the moment, but is it trite to say investing at the moment is more difficult than ever, or is it always difficult?

HD: I don't think it's always difficult because when you find a great business and you want to stick with the business for a long time, it's not that difficult. But sometimes finding them is difficult but once you've got them, sticking with them isn't that difficult.

People need to understand that this environment is potentially different this time, and normally we should never say it's different this time. The valuation of equities relative to economic output is the highest it's been in 100 years. And it has jumped very materially with the stimulus in the last 18 months. Not relative to current earnings because earnings are elevated the moment, but compared to the total output of economies, we are off the charts in equity market valuations and normally that will put a little question mark in your head.

But we're also at the end of the stimulus cycle, and we're about to go into a stimulus tightening and then we've got this threat of inflation out there. And for the last 15 years, every time there's been a correction, the central banks have rescued the market by printing more money. If we have inflation this time around and interest rates at zero, that game's up. I do think the situation is different and that the game book is different. If we get into trouble, it could be much uglier this time because there are fewer things the central banks can do in an inflationary environment to rescue the situation.

GH: You just said that, if we have those factors, this time the 'game is up'. What are you actually looking for in a signal prior to the market going down 30%, that tells you the 'game is up'?

HD: Well the markets being off 30% would be a good result in the 'game's up' scenario, I'd probably put the market off 50% and I'm being serious about that.

In the 'game's up' scenario, where inflation is persistent and the US Fed Reserve later this year has to start tightening monetary policy materially faster than just a sort of a normalisation. I really think we could be in a world of pain if that was to happen. I think there are two things you need to look at to make a judgment call on the inflation 'game's up' scenario. There are very strong arguments about these inflation pressures. The US has just printed 7% inflation, it's staggering having inflation at that level, and Australia is of course going up, but the US is what sets equity markets and we have to watch the United States.

We would expect when economies reopen from omicron we should get a change in demand for goods. A lot of people were at home buying goods, they were buying more televisions and stuff for the next barbecue and gym mats ... we were over-consuming goods at the same time as supply chains were constrained. So you'd expect as we normalise human activity, we'll start switching out of goods and into

services, going to restaurants and holidays and that should take pressure off supply chains.

A lot of this wages inflation is because Australia doesn't have 300,000 students here. How many of them work in restaurants? And tourists who come here, many are under 35 and they work at the farms and other places. None of them are here and this is before you even get to the migration debate. So reopening borders should actually get a deflationary force coming through the economy.

So I don't want to paint it's all inflation. I think this is quite evenly balanced at the moment. But we are starting to see in the United States material movements in consumer expectations. You have to think about the US consumer and what they are experiencing, not what economists are publishing. We've got elevated energy prices that the economists strip out, but look at utility bills, up 15 to 35%. Even the standard shopping basket, we have things like eggs and bread going up 30%. All the companies we speak to are starting to put through material price increases, such as McDonald's last year put up prices by 6%. Expectations change and the wages cycle starts moving, that is when the central banks are in the corner. So if we don't get this rollover effect (from goods to services) before people's expectations of prices change, I think we've got a problem in the US.

The other one is China because they are the world's supply chain. And unless China relaxes its zero COVID policy, we are going to have continuous stop starts in the supply chain and that could extend the persistence of supply chain constraints and make the inflation risk more.

I'm not saying the game's up. I'm saying there is a material risk it could be up. I think we're in a world of pain because of monetary policy being tightened, we're ex-stimulus, but if we really have to move monetary policy in the United States, it's kind of 'hold-on-to-your-chairs'. I don't know how these balls will drop.

GH: It's a fascinating time. We have a family business and every week a new letter comes in from suppliers about the rising cost of jars, freight, ingredients. And expectations get embedded into the system.

HD: When people start feeling it everywhere and then they say, well my wages are going up 3% and prices going up 7%, I'm going backwards here.

GH: You recently described your portfolio as having strong defensive characteristics but we see a lot of the leading tech tech stocks, Alphabet, Microsoft, Netflix. What's your argument that it's a defensive portfolio?

HD: We actually have two portfolios in the strategy. So 50% of our portfolio is in businesses like Nestle, PepsiCo, Procter and Gamble - which owns probably the biggest collection of consumer brands on the planet. We own utilities, we own some infrastructure stocks and we have a bit of cash. So half our portfolio, which is much greater than the market, is in very defensive businesses. But you're right on the other side of the portfolio, we've then got some more growth assets. Some of those are defensive but some of them are less defensive but they're incredibly long-term compounding stories.

If you just have a look at what the results from Alphabet were this week, which owns Google, the revenues were up 32%. If you look at Microsoft, their revenues were up over 20% in the last period, absolutely incredible. We've got businesses that are transitioning their business models, in a technology sense, like SAP. That transition is going to have nothing to do with inflation or any of these debates. Their business is about how they transition their 40,000 customers from a business model of on-premise to the cloud. That's their story. It's idiosyncratic to a lot of the issues you're talking about.

We have Visa and MasterCard, they're a royalty on spending around the world. But if we get inflation, they're a royalty on inflation as well, but sure there is economic sensitivity in part of our book. We effectively run about 80% of the risk of markets in terms of the overall exposure to volatility. You have to look at how the whole thing works together.

GH: You recently said, *"Why would I invest in turnaround stories when there are so many great companies"* and that's actually the reverse of what a lot of fund managers say where they look for beaten up companies, the ones which have problems, where share prices are marked down by the market. They buy the turnaround, but you don't accept that proposal.

HD: It's a difficult way to make money. Buffett has a famous saying that turnarounds seldom turn. Normally, when you're buying into turnarounds, the businesses are going backwards, have been overearning and they're having to reset themselves. And in all of that reset, they're incredibly time dependent. And I would say time is the enemy of a turnaround, because often your rate of return is depending on how quick that turnaround can happen. Because they're businesses that are struggling, they don't compound over time. You're looking for an earnings reset story, margin reset story and then a re-rating by the market.

If you invest in wonderful businesses, that compounding and time are your friends. The longer the time goes on, the more money you're going to make because it's a simple law of compound interest. So we want to be in compounding stories. I wouldn't say we never invest in a turnaround, but it's much more difficult. We believe in the magic of compound interest and turnarounds aren't compounding machines.

As Benjamin Franklin said, money makes money and the money that money makes, makes more money. And that is what investing is all about. It's putting away some money today and letting that money work for you over time. So it is just how we're philosophically wired.

GH: Before we turn to audience questions, last one from me: What question should I have asked you?

HD: Well, the question you shouldn't have asked me is what keeps you awake at night? Because that's a question that most people ask.

I think a great question when you're an investor, is if you had to own one company for the next 10 years, what would you own? How would you go through an assessment in making that decision? You'd first start to ask, what are the competitive advantages of the business? What are the threats to the business? What are the threats of disruption? What do you think their revenues will grow at for the next year? How confident are you? What do you think the competition looks like in that industry? Because you're only making one shot, you don't want to lose your money. You don't start thinking about the stock market and the relative returns. You think about the business. And that's how we think.

And if people ask themselves that type of question, they would think very differently about how confident they are. People get caught up with market movements and everyone piles in at exactly the wrong time.

If I could nominate one company, it'd probably be our largest investment, Microsoft. I think their cloud-related businesses and the diversification have so many advantages and where they're priced at the moment. Over the next 10 years, I would be very confident of putting 100% of my money into Microsoft, and never getting an opportunity to see what its share price is for another decade.

I'd be confident about putting my money in Nestle although I probably wouldn't get as high rate of return. I'd be very confident in PepsiCo, I'd be very confident about Intercontinental Exchange. There are some businesses that I'm probably not be as confident about in the next decade, such as Visa or MasterCard, fabulous businesses but there is some disruption out there.

As an investor, you're not thinking about the market, you're thinking about the business and what type of businesses you want to have your money invested into.

GH: Let's turn to some audience questions. How do you suggest managing equities in a rising rate environment?

HD: Yeah, a rising rate environment is difficult, particularly if rates go up meaningfully. If rates going up 0.5%, it isn't going to make much of a difference but if rates go up 2 or 3% is a very significant headwind. Warren Buffett describes interest rates as the gravity of markets. Asset prices are the discounted value of future cash flows and if you increase the discount rate, the value of those future cash flows go down. That's why interest rates are a headwind.

How do we manage that? We want to have businesses that inherently have pricing power and we want them to have low capital intensity, that hopefully they can be growing their earnings in line with inflation.

The other thing is the multiple of earnings changes. So something that may have traded at 22 times earnings may trade at 20 times with higher interest rates. That change has a short-term impact but it doesn't compound over time. You want the ability to compound real earnings (earnings adjusted for inflation) over time. If interest rates jump up, markets are going down, we're going to get affected and everybody's going to get affected. So as an equity investor, if we get a big jump in interest rates, I can't promise anyone we're going to go up, that is completely unrealistic. I think our portfolio is much higher quality and has much better attributes to deal with that world.

GH: Do you feel you relied too much on the China story, particularly given some of the controls that the Chinese government has imposed on certain businesses in the last year or so?

HD: It's a very good question. I made a mistake on China. I got overconfident in China because I really liked the businesses in Alibaba and Tencent. They're wonderful businesses but I underestimated the Communist Party risk. And it's really a regulatory risk, which happened after the IPO crack down. We bear certain regulatory risks. We bear it in the payment sector, where we bought Western technology companies, we bear it in stock exchanges when we invest in them, and in clearing houses.

So we understand regulatory risk but the biggest mistake on China was owning two technology companies, and they both got caught up in a regulatory crackdown. We now have less than 4% of our portfolio in China. We don't think China is uninvestable, but you really have to think about that sort of risk in China and manage that in your portfolio.

I'll accept completely I made a mistake, but you know, you make a few mistakes in your investing career, it's what you do about it. We've taken action. That China regulatory risk is never going to be material in our portfolio again.

GH: Are you concerned that your US-specific exposure is too high given the particularly high valuations in the US market and are you looking at opportunities in other countries?

HD: This is always a bit of a misnomer. We have 70% of our portfolio in the United States and nearly 60% of the (global) MSCI is US companies. So we're not that much different to

the overall market. But when we look around the world and we look at the valuations, the US market as a multiple is higher than other markets, but the United States has many more tech companies than other markets.

When we go around the world, we don't suddenly say, look, consumer staples are much more expensive in America and cheaper in Europe. It's just not factual. We don't find banks more expensive in America compared to banks in Australia or Canada or the UK. So I think you have to be very mindful that aggregate market multiples do not tell you what individual companies are worth.

And whilst we look like we're overweight United States, we are overweight global multinationals. Coke has only 20% of its earnings in America. You might think I'm making a bet on America if I'm invested in Coke, but 80% of their earnings are outside of America. Nestle which is a Swiss company but only 2% of their earnings come out of Switzerland and 34% of their earnings come out of America. So Nestle is much more American than Coca Cola is.

Many of the world's great technology-related multinationals came out of Silicon Valley and Seattle. We invest in the companies, not where they're necessarily listed, per se. We've got very few what I'd call domestic US plays, so we're not taking a particular play on the US itself.

Hamish Douglass was Chairman and Chief Investment Officer at Magellan when he was interviewed at the Morningstar Investor Conference on 4 February 2022. Magellan Asset Management is a sponsor of Firstlinks.

Mike Murray, Australian Ethical: Watching for the changing narrative

9 February 2022

Australian Ethical explains its first move into active ETFs, Murray's best investments and one he'd prefer to forget, a stock he will hold for 10 years, and why they hold supermarkets that sell tobacco and alcohol.

Mike Murray is Head of Domestic Equities at Australian Ethical, which manages over $6 billion in Australian equities and multi-asset funds. Australian Ethical has launched its first ETF, the High Conviction Fund (ticker: AEAE).

GH: After a long history of funds in the unlisted space, what has motivated the launch of an active ETF and why this particular fund?

MM: There's been a huge growth in demand for ethical investments and people want something that's true to label and ultimately it needs to be accessible. That's where the ETF comes in. It's a good product in terms of the ease of use and not having to fill out all the paperwork that typically goes with a managed fund. And while there have been a lot of fund launches in the sustainability space, there aren't a lot of true domestic ethical active managers in the ETF space. So we thought there was a bit of a gap there.

GH: You've chosen the High Conviction version, what was behind that?

MM: High Conviction means a more concentrated strategy than some of our other strategies. It aligns with our ethical charter and active management, looking for sustainable business models but it also plays a bit higher up the market capitalisation curve. It holds some small caps but it is a bit more overweight some of the mid caps and larger cap stocks, and that gives it a bit more dividend yield. It's not really reinventing the wheel. It's an extension of what we're already doing.

GH: What will be the maximum weighting allowed in any one stock?

MM: Up to 10% in an individual name but that's unlikely in practice, we'd expect 5% to 7% would be a typical position for a larger capitalisation stock.

GH: ESG and sustainable investing is pretty much mainstream now, you hardly find a fund manager who doesn't claim to operate under these principles. How does Australian Ethical maintain a point of difference?

MM: It's a good thing that it's mainstream, but we've got an ethical charter that's really unchanged for 30 years, and we only do one thing. Probably a slightly more nuanced point is that we don't think ethical investing is exactly the same as ESG. Ethical investment goes deeper, it's more about values, aligning the portfolio with the values of the client. We think some things have inherent value, creating a positive impact on people, the planet and animals. Those things have inherent value that we can't necessarily measure in risk and return.

GH: You've been at Australian Ethical since 2016. What's been your best investment decision over that time?

MM: A company that's done very well in the last five years is Fisher & Paykel Healthcare, a very innovative company and that's one of the keys to their success. They had a core technology relating to humidification of ventilated air in hospitals and so they benefited from making a positive impact in the COVID setting. They moved into CPAP and the nasal high flow, which is a type of oxygen therapy. The share price over five or six years has gone from $10 to $30. We're not actively adding to the position but we like the management, its organic growth profile and the business model.

GH: And on the other side of the ledger, is there a stock that you sold recently that's made you think about your investment process and how you analyse investments?

MM: Well, not a company that we've sold recently but it's under takeover. One that hasn't gone according to plan is Australian Pharmaceutical Industries, API, the pharmaceutical wholesaler and they also own the Priceline franchise business. We believed in the Priceline footprint and the company met our ethical hurdles as well. But shortly after investing in the company, the management changed and became more focused on acquisitions rather than organic growth, some outside their core competency. It hasn't really delivered in terms of earnings. The lesson is to watch for changing narratives in companies when you're meeting with them. When a company starts acquiring outside its core, sometimes it tells you something about their core business and the growth profile.

A slightly more nuanced thing is that we have done much better at product-oriented companies than service- oriented companies. A case in point is aged care, which was a hot sector for a while but it hasn't really delivered, it hasn't scaled, and we think product-oriented businesses scale better than personal services.

GH: Do you own a stock that you expect to keep for a long time, maybe 10 years?

MM: We are very patient providers of capital but when you're a fund manager, a lot of things change in 10 years, you might even see two or three CEOs. You can see companies get very overvalued or very undervalued in that period and if a company becomes very overvalued, we would sell it. Cochlear is another company we've held for a long time, it's a market leader and the business does tremendous social good and their markets are under penetrated. They've got a high gross margin. They probably raised too much capital during COVID which was very conservative as business bounced back much quicker than people expected. They've ended up with $500 million of cash on the balance sheets, they're conservatively geared. So you pay a high PE but over a 10-year period that will come down, given the strong growth rate.

GH: And a good business to own for the previous 10 years as well. Can I delve into your ethical process a bit more? When you're assessing a stock like Coles or Woolworths, which both sell tobacco, alcohol, sugary products, which are on the negative side of the ethical ledger. How would you weigh up owning a stock like that?

MM: That's a really good question. We distinguish between companies that are direct producers of some of those harmful products … and we do think they're harmful, there's no real debate about that. In this case, they are retailers, we would not classify them as direct producers, they are indirect participants in those markets. The second part is: are they selling more than their natural share of those products and are they strategically involved in those industries? We don't think those companies have an overweighting in those areas.

And then we ask if there are other positives in the business, and we think the answer is yes. Both those businesses are important in the overall economy. Coles is held in the High Conviction strategy and is committed to 100% renewables by 2025. They are signatories to the alcohol beverage advertising code, we can see quite a lot of positives. None of these companies is perfect so we're always making these judgements.

GH: Do you own any stocks now which may not have passed your ethical screens, say five years ago?

MM: We've seen both sides. We no longer invest in Tasmanian salmon producers for ethical reasons. But on the other hand, a company like Downer moved out of the mining contracting space into more of a light footprint, urban contracting business with a big role to play in energy transition. In building, there is a commitment from some businesses to a lower footprint and newer technologies, such as Fletcher Building and Boral. And in other cases, the end use of a product has changed, such as with lithium. Traditionally, we would not invest in mining companies but they are important for batteries and decarbonisation.

GH: Finally, any new developments at Australian Ethical coming this year?

MM: There's enough going on in the field of ethical investment to keep us occupied. You should expect us to stick to our knitting. We don't have a big presence in active international equities at the moment. That's something with some very interesting technology addressing society's problems. And more ETFs as we look across our product suite, they are on the radar.

Michael Murray is Head of Domestic Equities at Australian Ethical, a sponsor of Firstlinks.

John Woods, Australian Ethical: Diversification using asset allocation

1 December 2021

All fund managers now claim to take ESG factors into account, but a multi-asset ethical fund will look quite different from a mainstream fund. Faced with low fixed income returns, alternatives have a bigger role.

John Woods CFA is Head of Asset Allocation at Australian Ethical, which manages over $6 billion based on principles in its ethical charter. The multi-asset funds are Balanced, High Growth and Diversified Shares.

GH: John, let's start with a personal question on how you started in funds management.

JW: It was a circuitous path. I started my career as a software engineer, working in industrial automation and business intelligence. I found the best data was in the finance industry, so I started to research companies, initially in the telecommunications sector, which was aligned with my background. As I broadened into other sectors, I became an Asian strategist with a focus on emerging markets. I moved more into macroeconomic research and then multi-asset roles. At Australian Ethical, I put it all together based not just on the financial impact but an ethical lens as well.

GH: And if you could speak to your 25-year-old self who might be starting on that journey, what is one lesson you would give yourself?

JW: There are many but maybe the most important is to keep an open mind. Predicting the future is really difficult. As an example, if you recognised the potential of say 3D printing at an early stage, there were many companies involved, but you would have been better investing with the big, established technology companies. It wasn't that you couldn't see a trend happening but the hard question is how to take advantage of that trend.

GH: So even if you identify a theme, you then need to work out how it translates into financial performance?

JW: Yes, and economies are at a transformative moment in time, where the world is pivoting towards more sustainable, climate-related outcomes. That's fantastic for the planet and potential investments but you need an open mind on how you implement. It may not be as obvious as just buying the newest idea.

GH: In your asset allocation role, what changes have you made recently and in particular, how are you handling the defensive allocations with interest rates so low?

JW: The major change is we're increasing the level of alternative assets. Defensive assets have lost some of their diversification benefits but we don't lose sight of the primary role of fixed income assets is to protect capital. The income component comes second. It was great when defensive assets paid you to hold them but we haven't been in that environment for some time. Fixed income will still protect portfolios during severe equity sell offs.

But we also need to protect against rises in real interest rates which permeate across multiple asset classes. We're handling the need for diversification by bringing in new things, such as alternative assets. They comes with different equity risks than the rest of the portfolio, such as global businesses with a reasonable equity risk premium.

GH: What are specific examples of alternatives and why do they have the right defensive characteristics?

JW: Alternatives for us are areas like private equity, infrastructure and venture capital. We're specific about the way we implement them to justify bringing illiquidity into the portfolio. The institutions who bring us these investments must find assets that we can't find in listed markets, particularly in the venture capital space. A lot of emerging technologies, such as dealing with climate change or providing food, are in that venture capital space with different drivers than the broader equity market. They've still got an equity risk premium but we have to work out if the entrepreneurs are able to take the company from a startup to the next phase.

GH: Do you gain exposure to infrastructure through managers who specialise in the asset class?

JW: Yes, and aligning with our values, such as agricultural infrastructure or medical infrastructure.

GH: Other than the trends that Australian Ethical is known for, such as climate change and ethical investing, are there any other market trends that you're particularly backing at the moment?

JW: Well, more a subject that we're trying to solve for in a high-growth portfolio is managing inflation over long periods. A traditional response might be to invest in energy but a sector like oil may not have much of a future. So we're focused on other ways to capture exposure to inflation, such though the carbon price. If carbon becomes a cost of energy

production, we take protection through owning assets in the natural capital space.

GH: What do you mean by 'natural capital'?

JW: Assets such as water, forests and clean air. Natural capital is a way of thinking about nature as a stock that provides benefits to people and the economy. In researching a company, we check their use of water, greenhouse gas emissions and other factors that may harm to the natural environment. We look at reporting which deals with all the 'six capitals': not just financial and manufactured, but also intellectual, human, social and environmental capital.

GH: Is there a part of your equity portfolio which differs materially from the index?

JW: The market overlooks a lot of opportunities, especially as many asset managers as heavily benchmark aware. We try to look where others don't. For example, our portfolio doesn't include just the top four banks, as we have an overweighting to BOQ and Auswide. In telecommunications, we have Macquarie Telecom and Telecom New Zealand rather than just Telstra.

GH: One of your VC exposures is to CSIRO's venture capital business, Main Sequence. What attracted you to that and how does it fit in a multi-asset portfolio?

JW: When many people think about venture capital, it sounds high risk. Now, each individual investment that venture capitalists back might be high risk, but when you build up a portfolio, those idiosyncratic risks are diversified away. What attracted us to Main Sequence was the high level of alignment. The types of problems they're trying to solve are the problems we're trying to solve.

But every venture capital investment I've ever looked at sounds fantastic and exciting, but finding a group of people that can actually sift through that excitement with real knowledge is difficult. And that's where the link into CSIRO is unique. They have some of Australia's best scientists who can answer some of those really difficult questions. In a world awash with liquidity, we need this discipline to ensure we are not overpaying for assets. Main Sequence is setting up companies to solve problems from the ground up, paying the capital expense of a startup rather than a high valuation multiple. That's a powerful differentiator.

GH: These days, every fund manager talks about ESG and sustainable principles. How does Australian Ethical differentiate itself from what is now common practice among fund managers?

JW: It's good to see other fund managers taking ESG into account, it's a positive trend for society. But inevitably there will be more greenwash, so we encourage investors to engage with the impact they want from their investments. Serious ethical investing creates portfolios different to mainstream funds with different risks. We've been doing this for more than 30 years, with ethics and frameworks embedded in our investment philosophy.

GH: So how do your diversified funds differ from others?

JW: Our high-growth fund is built for investors with a much longer time frame in mind. We recommend a minimum investment period of 10+ years. We want to take advantage of early impact investments and more illiquid investments in the private equity and venture capital space. So it is 100% growth asset fund and the way we manage risk is by building diversification within those asset classes. It's still multi-asset, like a balance fund, but it has a more singular focus on growing capital over a very long time.

GH: Let's finish with what keeps you up at night.

JW: Inflation worries me at the moment but I also think about risk management knowing that with every risk there is an opportunity. For example, being invested in the world's largest equity market, the US, has produced great returns, but will we see that cycle repeated in the same stocks? I doubt it. We are experiencing a proliferation of new technologies coming to market and we have the opportunity to sift through them to deliver good returns, missing those opportunities keeps me awake to.

John Woods is Head of Asset Allocation at Australian Ethical Investment, a sponsor of Firstlinks. Media Release, 29 November 2021 - Australian Ethical doubles down on climate & tech solutions with inaugural 2021 Visionary Grants, via the Australian Ethical Foundation.

Sir Frank Lowy AC: "Trust your instinct" in conversation with Hamish Douglass

3 November 2021

Sir Frank shares his story, including his journey from war-torn Europe, identifying opportunities, key character traits necessary for business success, and the importance of remaining paranoid yet optimistic.

Sir Frank Lowy AC is the former long-time Chairman of Westfield Corporation, founder of the Lowy Institute, and chairman of the Institute for National Securities Studies, relating to Israel's national security and Middle East affairs. This is an extract of Sir Frank's recent chat with Magellan's Hamish Douglass.

Hamish Douglass (HD): Frank, firstly, to start, would you be able to provide our listeners with a brief background on your childhood and education and ultimately your journey to Australia?

Sir Frank Lowy AC (FL): Well, Hamish, the beginning of my life was very turbulent. I was born in Czechoslovakia in 1930. Eight years later, it became Hungary, so I was a Hungarian. Antisemitism was very difficult for us to cope with. In the town where I was born, there were about 5,000 inhabitants and 150 Jews. Business was difficult. The anti-Semitic laws prohibited us from owning businesses. So my father in 1942 decided to move to Budapest where we were able to mingle with the world without it being known that we were Jewish.

Life was quite good in spite of the war already raging. It all came to a sudden stop on the 19th of March 1944. The German army occupied Hungary and life turned terribly worse. I lost my father the next day because they caught him in the street, and I haven't heard from him since.

I was left with my mother, sister and brother. I went into hiding and I stayed with my mother. It's a very long story, it was a very difficult time. But by the end of 1944-45, the war was over for us and we went back to Czechoslovakia, which then became Slovakia. So you can imagine how many nationalities I had to cope with.

Only 35 Jews came back [to my small town]. So it was a very sad place and it was mainly males, and I had no company there. I didn't really want to go back to school. I decided to emigrate to Palestine at the end of 1946. I joined the Israeli army in 1947, fought in the Arab-Israeli war, and afterwards I got a reasonably good job. I learnt accountancy at night, got a job in the bank and I enjoyed myself very much. But I was very much longing to be with my mother and sister and brother who survived the war, and they, meanwhile, [had] emigrated to Australia. So being in Israel, then for about six years, I decided to join them, they sent me the air tickets and I arrived in Australia in early 1952.

HD: Frank, I don't think many listeners unless they are probably over 70 or 80 have any appreciation of that background. Many of us complain about issues that are going on in the world, but we have lived our lives in very peaceful times. You grew up in a horrendous period of antisemitism, and loss your father at a young age. Family is so important at the end of the day. What are the lessons you learnt from your parents that you're trying to pass on to your three sons and your grandchildren?

FL: Both my parents, together and individually taught me to be charitable, to share. And I do remember it well, but once we discussed it and my mother said: "If you have a little, give a little, if you have a lot, give a lot".

That became my ethos in life. Of course, the difficulties during the war also taught me to be vigilant, to be paranoid. And it taught me a lesson about if you want to succeed or survive, you need to be curious to see what's going on. Where are the opportunities for various activities of your life? And I think it did give me some grounding to my life later on.

HD: And maybe that's a good segue from family into business. In 1955 you and your business partner John Saunders started out as partners in a delicatessen in Sydney. And how did the partnership in a small delicatessen lead to the establishment of Westfield Building Corporation? That seems quite a leap.

FL: Yes, it is something I wonder myself, but looking back is a lot easier than looking forward. Most of the decisions that we took were strategic business decisions. We could have opened the delicatessen in Bondi junction or in the city, but we had two opportunities: one in Bondi Junction and one in Blacktown. John lived in North Sydney and I lived in Dover Heights, and we chose Blacktown not because it was close and convenient, but because the opportunity in Blacktown seemed to be a lot better than in Bondi junction.

Immigrants were pouring into Sydney, and most of them went to the western suburbs. So we decided to go there and didn't mind the travel of an hour each way.

We left about 7:00am from Sydney, opened the shop at 9:00am and then came home 7:00pm or 8:00pm at night.

But as I said, looking back, it was a strategic decision to go to Blacktown and why? The shop we rented was opposite the railway station. One day it was quite afternoon and I walked in the street to look around, and I see about three shops are being built next door to our delicatessen. I told John “listen we could do that”. So we decided to try it.

But beforehand, we also opened a coffee shop next to our delicatessen, and it was the first or second espresso machine in Sydney. There were a lot of Italians living in the area, and the coffee shop was opened on Sunday. So we were working seven days a week. Shirley and I used to get up Sunday morning, take [my eldest] David to my mother, then go together to the shop.

So we built those few shops next to us. I think it was four shops, and it was very successful. We rented them and [finally] sold them. So that was our first real estate venture. On top of that, the landlord of ours in Blacktown had four or five acres behind the shops next to the post office.

We thought, well why can't we try to buy it and build some more shops? We’d already heard about shopping centres in the United States, so we bought some architectural magazines, and we learnt a little bit about how to. We bought that piece of land, hired an architect, and created a small shopping centre of 12 shops, a small department store and parking for 30 cars. It was an unbelievable success. Meanwhile, we sold the delicatessen and the coffee shop, which gave us the capital to carry on business. We opened that shopping centre on the 9th of August 1959.

HD: It's incredible that you chose Blacktown because of immigration there. And then when you were in a delicatessen, you expanded into real estate and you just saw an opportunity. So it wasn't like you went to Blacktown to build a shopping centre. The plans developed as you could see things as they were happening.

FL: Practically my whole business career was instinctive; I have an instinct and then I do the research about my instinct. And that's the way I made decisions.

I'm very curious and, as you know, I'm paranoid. But at the same time, I'm an optimist because you cannot be a real estate developer without being an optimist. The paranoia must follow you, and that's how I think I can attribute my success; to those feelings and then the people I choose to be with.

When we sold out of Westfield there were people who used to work for me, started as young people and 30 years later there were still there. Of course, I was very lucky to have three sons like David, Peter and Steven, who are smart, hard workers, and also I think there is an optimism in the four of us and also the paranoia. I can't quite describe it to you, but the mixture of those does wonders.

HD: Frank, you once said to me, "always play the ball and not the man". But how do you avoid playing the man when you're playing tough to get outcomes in business?

FL: I think what I used to do is decide by myself where I want to be in those negotiations. And I just didn't give in. I kept my point. Occasionally in business, you have to give in, to give the other guys some victory also. But I decided where I wanted to be at the end of the negotiation, and once I got there, there was nowhere to go.

The opponent must have realised this, because you need the buyer and the seller all the time. Somebody has to be definite. I was definite because I believed that's the way to go. I don't like these negotiations that drag on for a long time. I lose patience and I know where I want to be. So why play around? Just state your position and stick to it.

HD: Frank, I'm going to move on from Westfield a little bit, and I haven't asked you this question before, so I'm incredibly interested in the answer. You have had a great privilege of meeting so many people around the world in your life, who has impressed you the most and why?

FL: You'll be embarrassed by my answer. One of the men is you, because I felt when I talked to you like I was talking to myself. And of course, it's enjoyable to meet a smart person. And every time we were together, we learnt from each other. Life is about learning. Not standing still, and I learnt a lot from you, and I'm very pleased to hear from you, from time to time, how much you enjoy the interaction between you and I.

There are also a lot of other people that influenced me. I [also] enjoyed working with my sons. We get on well, it is not a honeymoon that we agree all the time with each other. We respect each other. So when we debate, at the end there is a consensus. There is no better way to make decisions.

HD: We have fascinating conversations, Frank, and I'm always amazed. You've just turned 91, so how do you retain so much energy and such a positive outlook? You’re still moving with a lot of energy. You still move around the world. COVID probably slowed you down a little bit, but how do you retain a positive outlook and energy in life?

FL: Well, I think I am very interested in what I do, which I probably inherited from my mother and father. I am very curious. I don't want to stop because I'm 91. I'll stop when I have to. I enjoy what I do. I enjoy my activities in the Lowy Institute and the [Institute for National Securities Studies] that I chair here in Israel for the Middle East.

Life is very interesting if you are interested, and I don't spare myself energy. What I inherited, and the energy I have, is a combination of luck, interest, and curiosity. I get up in the morning around 6:00, and I go to the gym. I spend a couple

of hours there before I start [the day]. You know, it's a lesson that you get energy in the gym. I might do some swimming and come up for breakfast.

HD: And Frank, one very last question to end here. Every time we get together, I must admit, I come back more optimistic and more energised than I was before we get together. A lot of people are very pessimistic about the world at the moment. What are you most optimistic about?

FL: I think that life rolls. It doesn't stop. I failed to bring the 2022 [Soccer] World Cup to Australia. I was miserable. Of course, I was cheated out of the position, but I came back from Zurich, and I had to face the music. The journalists were waiting for me, and I accepted the great responsibility and I said, "You know what, fellows? The Sun will rise tomorrow", and I finished my interview that way.

The Sun did rise. So what am I optimistic about? The same thing. It's a bit of a cliché, but of course, the Sun will rise tomorrow.

HD: Well, Frank, I couldn't think of a better note to end on. I hope to see you back at home in Australia and I know Tel Aviv and New York is also home. But Australia is a very important part of your life. You've got a lot of friends here, you're also an incredible businessman, but most importantly, a friend and a mentor and somebody who I admire and I'm very lucky to call a friend. So thank you very much, Frank.

FL: Okay, thank you very much, Hamish, and I hope to see you soon.

HD: Likewise.

Hamish Douglass is Co-Founder, Chairman and Chief Investment Officer of Magellan Asset Management, a sponsor of Firstlinks. You can listen to the full interview here.

Jacob Mitchell, Antipodes Partners: My biggest investing lessons

29 September 2021

Jacob Mitchell spent 14 years at Platinum before establishing Antipodes in 2015. He discusses trends he is following, his biggest lessons, LICs versus active ETFs and a stock he will hold for at least 10 years.

Jacob Mitchell is Founder and Chief Investment Officer of Antipodes Partners, managing over $8 billion and part of the Pinnacle Group. Jacob spent 14 years at Platinum Asset Management before starting Antipodes in 2015.

GH: What attracted you into this business at the start?

JM: Even in high school, I was interested in understanding linkages between business, the world economy and politics, and looking up the stock pages - what it meant and why share prices react. It became a lifelong pursuit, and I was fortunate to start my career with a fundamental approach to company analysis and (at?) an early quantamental shop. That put me on a journey to global equities at Platinum and then to starting Antipodes in 2015.

GH: And if after all this time, you could go back and give your 20-year-old self one lesson which you didn't fully appreciate at the time, what would that be?

JM: As we've gone through each cycle, policy responses have become more and more dramatic, and we've now gone way beyond cutting interest rates to extraordinarily imaginative policies with QE and central banks socialising credit risk. The key lesson is don't underestimate how pragmatic central banks will be in the face of weakening economies.

And western central banks, especially, are committed to protecting asset prices as the key transmission to the real economy. They talk about targeting inflation but really, they're targeting and supporting the economy via higher asset prices – understanding, in my earlier years, how extreme this would become would have been helpful.

GH: Yes, it has been extraordinary how much support the central banks keep giving. You specialise in global equities and we have seen more Australian investors allocating to global whereas in the past the home bias dominated. What do you tell investors are the main reasons to hold global equities?

JM: The great opportunity is to diversify from a relatively-concentrated Australian stock market, especially away from financial and resources, and also domestic economic risk. Australia is a concentrated play on the health of the local economy and the health of China.

And the other opportunity is exposure to sectors that are not represented in the local stock market, such as semiconductors, critical enabling technology where the leading companies are American, Japanese, Taiwanese,

Korean and European but not Australian. If you want to participate in certain parts of the market, you have to go offshore.

GH: We've had a great run in the market since the GFC and it recovered quickly from COVID. As purchase prices drive future returns, do you think it will be difficult for equities to perform as well over the next 10 years as they have over the last 10?

JM: Most definitely, yes. The best predictor of future returns is the starting multiple and that is elevated. It is very high in the US and the US represents roughly 60% of the global benchmark. So we struggle with the valuations for US equities, which are roughly 65% more expensive than the rest of the world, close to all-time highs. And then the other 40% is quite cheap in an absolute sense, certainly allowing for interest rates, and in a relative sense, as cheap as it's ever been.

GH: Compared with the US?

JM: You've got this bifurcation in potential outcomes, I think similar to 2000. There is P/E dispersion everywhere, even in the US and the US represents our largest exposure. Yes, we're underweight the benchmark significantly, but it's still a large exposure for our portfolio.

GH: It's very difficult to ignore the US in a global portfolio. What percentage of your book is in the US?

JM: In our long exposure, it's roughly 40% versus a benchmark of 60%. The average P/E valuation is hiding some very expensive stocks and some very cheap stocks, so we still think there are great stock picking opportunities and we do see different investment cycles starting to emerge, such as decarbonisation.

GH: Are there any big market trends you're backing at the moment and a couple of companies in this trend?

JM: Yes, we see reopenings emerge at a different pace around the world. One sweet spot in the next 18 months will be a return to cross border travel. Europe as an economy will do quite well and it has underperformed the US because it's so much more dependent on international tourism. So we broadly want to be exposed to Europe domestics, whether it's financials, specific travel exposures like Airbus and GE.

Then on the consumer side of travel, a company like Ctrip. It's the leading online travel portal in China with a high share of outbound bookings and a dominant position. It's a part of the market that's not experienced a proper recovery so stocks are quite cheap. It's a structural opportunity. We are constructive on the emergence of the Chinese middle class, and the aspirational premium consumers that we may have forgotten. But they will come back to travel. They love spending on luxury and that spending hasn't gone away.

The theme with deep implications is decarbonisation.

Investors often play conceptual stocks as opposed to thinking about what it really means, and it means a lot for power infrastructure. It will take years. It changes the fundamental underlying composition of capital spending towards power infrastructure.

It's a little bit like cloud computing. In the early days of the emergence of cloud computing and the evolution of SAAS software models, you really needed to work out what the longer-term implications were because it was a trend that will be around for a while.

GH: It will play out over decades. Are you seeing some winners in that space or is it too early?

JM: We like three themes. A utility company with sound regulatory protections that we like is Fortis, which will connect renewable energy to load centres. Then there's the 'picks and shovel' stocks like Siemens, which is well exposed to this capex cycle of reengineering the industrial base and reinforcing the grid. And third, companies in the materials space that need to decarbonise or build that power infrastructure. Switching the auto fleet to EVs changes the demand profile for copper. Also, aluminium has an excellent supply story as China has stopped adding capacity, and it has a great demand story as a lightweight metal. So those three buckets are all interesting.

GH: And you talk about the market "irrational extrapolating". What's a good example of that?

JM: Well, look at what's happening in China with tech regulation. We think the market is extrapolating in a somewhat irrational manner. We acknowledge the uncertainty but in some ways, China is catching up to the rest of the world in terms of anti-monopoly, consumer data protection, cyber security. We don't think this is a move by the Chinese Government to stamp out these companies in their provision of consumer and ecommerce services. They still want to encourage basic consumer services and successful businesses.

Look at patents which originate in China. There is a critical dependency and that innovation is coming out of the private sector, it's not the state-owned enterprises. I think the Government wants to coexist with the private sector and as investors, we should be able to navigate that uncertainty and use it to our advantage because I think it will reduce over time.

The strongest, largest and most dominant companies are in the best position to face that regulation, as we've seen with Facebook and the dominant tech companies in the world.

When uncertainty has come to the fore, it's typically an opportunity to buy the company cheaply. And then, as uncertainties dissipate, it's typically those larger companies that have the financial and business capabilities to implement the change. Ironically, the regulations have reinforced their dominance because they have the resources to deal with the issues.

GH: Let's look at your listed vehicles, the closed-end LIC (ASX:APL) and your plan to give investors the choice to switch into your open-ended active ETF (ASX:AGX1). Can you give some insight into why the Board chose this approach when other methods have been tried in the past, such as a tender offer structure, as the best way to remove any discount in the share price to Net Tangible Assets (NTA).

JM: AGX1, as an exchange-traded active ETF, solves permanently the NTA discount. So while we took a path to get there - buybacks, tender offer - it is the best outcome. It's the same approach, but within a long only rather than long-short strategy, same investment philosophy, same investment team. And combining the two gives better scale and solves permanently the NTA issue.

GH: Is there any concern on your part that whereas previously, you had locked-in capital, investors can now redeem from an active ETF, that maybe there will be some loss of funds?

JM: Retention of FUM is a function of communication and performance, and we think the future is active ETFs. If we do our job, we'll retain our investors but ultimately it's their choice, but we thought this was an elegant solution to the discount problem.

GH: A final question. Is there a stock in your portfolio that you're confident you will still hold 10 years from now?

JM: Well, repeating based on the great long-term opportunity, Siemens will reengineer industrial supply chains and power. If you think of the businesses that Siemens is in - supply chain solutions, manufacturing solutions, infrastructure, fortifying the grid, reducing emissions – we've never seen anything like this, and Siemens is going to be the stock. These are long-term capex growth exposures, and the growth rate will accelerate over the next couple of decades, and the market is significantly underestimating the long-term value of the company.

The stock I've owned the longest is Microsoft. It can be decades before the market efficiently prices the asset. Microsoft is getting there, Siemens hasn't even started.

Engineers, designers, once they're trained on these Siemens tools, it becomes similar to the Microsoft suite. It's easy to keep using it.

Jacob Mitchell is Founder and Chief Investment Officer of Antipodes Partners, managing over $8 billion and part of the Pinnacle Group, a sponsor of Firstlinks. This article is an edited transcript.

Sean Fenton, Sage Capital: Marching to your own investment tune

15 September 2021

Is it more difficult to find stocks to short in a rising market? What impact has central bank dominance had over stock selection? How do you combine income and growth in a portfolio? Where are the opportunities?

Sean Fenton is the Founder and Chief Investment Officer at Sage Capital, an Australian equity long short fund manager. Sage Capital has been nominated for the Rising Star category in the Zenith Fund Manager of the Year Awards 2021.

GH: Sage invests a little bit differently with a 'market neutral' fund that aims to generate returns independently of the direction of the overall market. It balances long and short positions, while your equity fund can also short stocks. Have the last 12 months of strong equity markets been particularly difficult for shorting?

SF: When we think about shorting, we're not necessarily just looking for stocks that might go down or fall in absolute value. Because we're a long/short fund, anything that we short is essentially reinvested back into the longs. With our absolute return fund or market neutral fund, the longs and shorts are balanced so that our stock selection drives returns.

In our equity plus fund, when we're shorting, we're actually taking extra-long positions. We might be 30% short but we're 130% long. That means the decision on shorting comes down not just to stocks that are falling but stocks that are underperforming the index. That's the key to generating active returns.

In any market, a whole range of stocks are underperforming and some are outperforming and our focus in shorting is on finding underperforming stocks. So while the market has been rising strongly, it's still been a great environment for active management with some things going up and some going down.

GH: In your equity plus fund, are you able to measure how much of your return has come from your longs and how much from your shorts?

SF: We've been running Sage Capital for a couple of years but long/short funds for over 20 years. Over the long period of time, it's fairly even. In the last year, the longs were doing better than the shorts as the market was really running and the shorts were funding the long activities. That started to turn around more recently with the shorts adding more value in the process as well.

GH: You wrote an article in Firstlinks about central banks dominating financial markets and reducing the efficacy of pricing signals on stocks. Is this central bank activity making stock picking more difficult?

SF: In some ways, it's more difficult but it's also opening opportunities. It's certainly something you need to take into account in building portfolios. The role of central banks with big QE programmes and negative real rates is manifested across the world. Everything from the value of your house to crypto currencies and non-fungible tokens. It's intriguing that the value of office properties has been rising despite leasing falls and vacancies. P/E ratios have gone stratospheric in many cases, so you've got to be aware of that as a risk. You can't simply fight and say stocks are really expensive because bond yields are very low, driving that dynamic.

It is driving a poor allocation of resources across the economy and we're going to pay the price for that in low growth. But in terms of stock selection, it's a risk and we try to be neutral to that thematic. One day, maybe not too far in the future, central banks may change tack in both winding back asset purchases and actually increasing interest rates, and that will drive a new dynamic.

GH: We've all needed to recalibrate what we think is reasonable value in a whole range of assets.

SF: Yes, I've gone from thinking a P/E over 20 times is expensive to now that's cheap, and you've got to be over 50 times to raise the eyebrows.

GH: Are there other big market trends that you're backing at the moment?

SF: We've been going short iron ore as the price had become so elevated and the market wasn't particularly tight as Vale in Brazil was gradually coming back and normalising. Then China was starting to peak out as well, and now we're seeing a new dynamic where China's policy focus is more on common prosperity. They also want to reduce their carbon intensity and wind back steel production. Another dynamic is Evergrande, one of the largest property developers essentially approaching bankruptcy, so we're seeing the property cycle roll over.

On the positive side, coming out of reporting season, insurance globally and domestically is strong with more pricing power for companies. Global business insurance is seeing double-digit increases. It's good for QBE and to a lesser extent IAG and Suncorp. There's some concern about business interruption but we see some long opportunities through the insurance cycle.

GH: Have you got a couple of stocks in your portfolio that you're most confident that the market is under appreciating, where it's frustrating that you see the value but the market doesn't?

SF: Yeah, that's the bane of every investor, the stuff that the market doesn't appreciate. You've got to be careful that you're not just marching to your own tune. You don't want to sit there for years waiting for everyone else to realise that you're right.

One that's like that at the moment is South32, it's really done nothing for a long time. It's gone through a transformation and now has an interesting mix with a premium aluminum exposure but also metallurgical coal and manganese. Aluminium has been very strong lately. They're generating massive free cash flow and they're in more of an ascendancy.

GH: Any industrial stock, perhaps a value stock left behind in the growth story?

SF: An interesting turnaround is Incitec Pivot, which had a whole litany of woes on the operational side, but we look at what's happening globally, with price strength in wheat and corn and increased plantings and use of fertilisers. Some missing parts are now sorted out, but the stock's been largely ignored and put on the sidelines. So, if they can show some operational stability, with a lower Aussie dollar, we see a potential value play and a turnaround opportunity. Although Hurricane Ida just rolled over one of their plants…

GH: What about the one that got away, the stock you look at each day that was on your radar but it didn't quite reach your price?

SF: We continually reassess and don't let things get away too much but one stock where we sat on the sidelines for too long is Xero. It's a company that has a unique product, a global rollout story with accounting software in the cloud space. But it's never really generated much profit as it's continued to invest in growth, on traditional metrics it's

always looks ridiculously expensive. We eventually took a position but it's one that we watched for a while.

GH: And is there one which you sold too soon, that has just kept running?

SF: James Hardie is one where we had a much bigger position a year ago. It's done very well to move higher, but we've taken profit along the way. We don't regret it but it's hard to buy back in once you have sold.

GH: Do you ever make a trade-off between income and capital growth, where you feel your portfolio needs income, but you might not get the price gain?

SF: We make holistic decisions looking at total return, with capital growth and income combined although there are different drivers. We split the market into different groups and in the growth group, there's not a lot of income being generated, it really is capital return. Whereas we've got another grouping, which we call yield, which is full of banks, where valuations are more important. And we have defensives including infrastructure and utilities, and income generation is given more weighting in those areas. But we're always looking at the trade off with capital growth.

GH: Can you give us some insights into your business, where the flows are coming from, any plans for listed vehicle?

SF: We've really been focused on the retail and wholesale market through independent financial adviser groups, we're available on a range of platforms, and we're getting good flows across different dealer groups. We don't have any short-term plans for a listed fund but it's something that we will look at to broaden that access channel. We're not big fans of LICs so a listed open-ended structure that provides liquidity without the NTA discounts has more promise. We're also setting up a structure for offshore investors.

Sean Fenton is Chief Investment Officer and Founder of Sage Capital. Sage Capital is an investment manager partner of Channel Capital, a sponsor of Firstlinks.

Christian Baylis, Fortlake Asset Management: Financial repression in fixed income

1 September 2021

Financial repression is suddenly part of our lexicon, but what is it and how can a fixed income fund take advantage of it? And why it is better to manage smaller amounts than multi-billion portfolios.

Dr. Christian Baylis is Chief Investment Officer at fixed income manager, Fortlake Asset Management, which was established in 2020. For 10 years before founding Fortlake, Christian was Executive Director and Portfolio Manager at UBS.

Financial repression includes policies which deliver negative real rates of return to savers to allow commercial banks and central banks to provide cheap loans to reduce servicing costs for companies and governments. It is called 'repression' because savers are not compensated adequately and there is greater government influence in the economy.

GH: How do you expect to generate returns in fixed interest?

CB: We're taking a different approach to the asset class. Fixed income can be simplified into risk and return, so we've structured our funds into one strategy and three different risk profiles, with commensurate return objectives. So in our short history, the lowest vol (*volatility*) fund has returned 7% with volatility of 1.7%. Keep that in the context of equity markets with about 15% volatility. In our medium vol fund, the return has been 10.5% with 2.4% volatility, and then the higher vol fund, it's been 15% return with 3.3% volatility.

GH: Those returns have benefitted from some tailwinds, where have the returns come from?

CB: The main point about where we generate our returns is through the financial repression thematic. Real interest rates can go deeply negative, they're not limited by the zero lower bound like nominal interest rates. Over the 1940s and 1950s, we had deeply negative real rates, such as negative 10% and negative 7% (*Ed note: these are nominal interest rates adjusted for high inflation to give real rates*). And this time around, central banks have tried to stoke inflation and keep interest rates low.

This opens up a big sea of opportunity between the nominal interest rate environment and the real yield environment, and moves into returns along the yield curve, duration, and also corporate structures. We can also play the capital side of this real interest rate thematic. We focus on the integration of these risk silos, so we have a broader opportunity set.

GH: In your previous role at UBS, you managed multi-billion-dollar portfolios. What are your current funds under management and how does it contrast with managing such a large portfolio?

CB: We've tipped over $500 million in the first seven or eight months. The comparison (*on fund size*) is that it's a lot easier. Your movement around the market can be done in an orderly way without gaining too much attention, whereas at the larger managers, the size of their strategic movements has huge impacts on the market. When a large flow goes through the market, it's very easy and well telegraphed by the brokers who tell other buy-side managers and other brokers what's happening. That affects pricing and the bigger institutions can actually have higher transaction costs, not lower transaction costs because the impact on the market is much larger.

The simple economics are that when we sell our bonds, brokers know there isn't another $200 million order behind it. They know that when we sell, we're probably done, and we don't need to sell to a range of brokers. They know our risk is reasonably limited compared to say someone with $50 or $60 billion under management. A broker doesn't want to be lumped with risk knowing that another broker is about to be lumped with it as well. That really starts to impact the market so that huge size can be a detriment to returns, particularly in a low-yield environment where transaction costs are so important.

Whenever I hear of managers talking about all the trading they're doing, I squirm a bit. It's bad for the end investor because they are chewing up returns with frictional costs. And that's really hard to get back, transaction costs are fixed and certain whereas the return side of the ledger is highly uncertain. To trade away a certain negative for an uncertain positive, one needs to be reasonably assured of the pricing of that risk. because we all operate in a world of uncertainty and there's always an element of risk in what we do.

GH: I noticed in your Real Income Fund's last report, you had 260 issues in the portfolio. So is there another side to being a smaller player? Are you able to command institutional prices when you're dealing in relatively small parcels?

CB: It's really about having minimal impact on the market. You're trying to be light on your feet and not being overexposed to one single part or point at the market or one particular issue. With large single-name investments, you're exposed to idiosyncratic risk. For example, who would have thought the Brisbane and Sydney Airports and stable names such as universities, would be under financial pressure? But we've had a pandemic, a one-in-100-year event. So spreading yourself across a range of different names is the better way to approach fixed income. There are much greater asymmetries in our asset class.

It's different with equities. You live and die by the upside. Fixed income lives and dies by the downside. An upside surprise for us might add a handful of basis points to performance but when you have a downside surprise, that can rip a hole in your return profile. If you have a 1% allocation to an issue that defaults and you lose 100% of that name in a low-yield environment, that can lead to 80 to 90% of the excess performance gone. You need to know what you're doing in each single exposure.

GH: And another fund, the Sigma Fund, has 68% of its exposure to Australian issues. Is the local market deep enough to find the best opportunities?

CB: You need a strong rationale to go offshore and buy bonds in a foreign currency. In crisis periods, currency hedges have large, outsized effects on portfolios when there are huge amounts of currency volatility. So our belief is that the core of the portfolio should be set up in very high quality AUD or domestic names, and that only special opportunities in offshore markets should be added into the portfolio.

GH: But is the range of issuers and types of bonds and liquidity good enough in the Australian market?

CB: Let's say about 40% of the domestic market is financial institutions and ADIs which are all repo eligible so the liquidity is good, and it's dominated by the major banks anyway. So we think the better way of structuring portfolios is to have a very clean liquid core. And then for our higher returning portfolio we can reach out for the higher-octane type of maturity or issuer. So you'll find that 70% of the fund is very stable but the other 30% swings around with the degrees of risk and opportunities that are out there in the global market.

GH: You wrote recently about how economies will be less resilient to shocks in future due to the massive spending we've seen in the last 18 months. It's notable that the market hasn't really delivered any adverse consequences yet, we still see the US 10-year bond around 1.3%, near the Australian level. The signs of inflation are not translating significantly into bond markets and we have equity markets at all-time high. Why are markets relatively complacent and do you see the threats and the weaknesses in the future?

CB: Again, this goes to the heart of the financial repression thematic, the magic that we're experiencing worldwide. Low nominal interest rates help to reduce debt servicing costs, obviously. A high incidence of negative real interest rates effectively liquidates or restructures existing debt. And so the simple arithmetic is that if you have $100 of debt, you've got 5% of inflation, effectively, you've been given a free restructuring of 5% of the debt, that's been wiped out just by inflation.

So that's what we call liquidation of debt or financial repression, that's inflation solving our debt problems if we

keep real interest rates very low for a long period of time. And so, financial repression is the most successful format, in terms of liquidating debts, and that's really what Japan's been doing or at least trying to do. That's where we're all going. We can run these high debt loads on the basis that inflation is going to pick up at some future point and solve our problems via an inflation led restructure.

So throughout history when you look at it, the debt to GDP ratios have been reduced by **one**, economic growth, **two**, a substantive fiscal adjustment or some type of austerity, **three**, explicit defaults restructuring private and public sector debt. And **four**, a sudden burst of inflation and **five**, a steady dosage of financial repression. The high-yield market has basically had no defaults since January 2021, so this repression is really working in bringing zombie companies back to life. Spreads have come a long way as well. Those markets, typically priced for 20% probability of default, are experiencing one-tenth of that.

And central banks are buying risk assets, buying high-yield bonds, buying state government debt, all this sort of stuff and it's creating this displacement effect where people like us sell those bonds to the government or the RBA or the Federal Reserve, and then we move down the risk curve and buy things like hybrids and Tier 1 debt, so everyone's just constantly ratcheting down into these high-risk parts of the market.

I think it's a time for being very conservative in the way we approach risk assets because we don't know what this will look like once central banks step away from these types of assets.

GH: And do you think that this is building in some vulnerability in the future?

CB: Without a doubt because we're too used to the medication that's been given to us. And the risk for us is that, once the stabilising beams are taken away, we have lost our market coordination, so to speak. There's been no psychological scarring and it's very easy to forget this ever happened. Who would have thought that with the biggest fall in GDP it would also be the briefest and condensed into such a short time frame? Moreover it is now accompanied by record highs in the equity market. This is the scale of the official sector involvement in our assets and that masks over what's been ultimately a horrific real experience in the economy. So there's a huge disconnect and it's all artificial and inorganic and we really need to see how this plays out.

GH: Yes, and one result is governments have been spending money to make wealthy people wealthier, so there's an inequity about all this as well.

CB: Yes, the savings rate that has gone up to 20%+ in the US and similar here and it is correlated and equivalent to the amount of debt that's been taken on by the public sector. It's been a huge fiscal transfer from government balance sheet across to the private sector and directly into those savings accounts. The consumer is bound up and ready to spend. They've got huge capacity on the saving side to come out and do what they need to do, and this goes to the unintended consequences on the inflation side when that gets unleashed. They are heavily incentivized to spend quickly as inflation exposed savings accounts are losing around 2-3% per annum. The real side of the economy doesn't have the capacity to respond to it due to the latency in scaling up supply chains, you may actually get disorderly inflation outcomes or at the very least the probability of this is far higher coming out of a one-in-100 year event. You need to be prepared and you need to be hedged for it.

GH: Finally, tell me about the access point to your funds. You don't have any listed funds yet, any plans in that direction.

CB: Yes, we do have plans to offer all our funds through an ETF format with Chi-X. We have the scale for a listed fund now and that's where the market is going.

Dr. Christian Baylis is Chief Investment Officer at Fortlake Asset Management, a boutique fixed income manager affiliated with Income Asset Management (ASX:INY), formerly Cashwerkz (ASX:CWZ), a sponsor of Firstlinks.

Emma Fisher, Airlie Funds Management: Picking companies not trends or themes

18 August 2021

Focus on what you're good at. If you have no insights on macro themes or market trends but can spot a great company, that should be your emphasis, while carefully watching entry and exit prices.

Emma Fisher is Portfolio Manager at Airlie Funds Management, the Australian equity manager within the Magellan Group. For a podcast version of this interview, see [Wealth of Experience](), Season 1, Edition 5.

GH: Your style is more to pick companies rather than themes but are there any big market trends or themes that you're backing at the moment.

EF: The short answer is no, as you say, we're really bottom-up stock pickers, but it's probably worth exploring why we don't try to pick trends. The simple answer is because I don't think we'd be good at it. I don't really back myself to identify thematics early, and by the time they're obvious when you turn to a certain trend, they tend to be overvalued for their near-term prospects. So that's why we've always shied away from it.

Another thing is, typically with trend investing you're talking about forecasting demand and I've always found forecasting demand difficult. I prefer to concentrate on supply because it's easier. Typically, you've only got so many players in an industry and you know the supply years in advance and it is supply coming online that tends to drive pricing in an industry. The obvious example is the miners in the supercycle when prices were high. All the supply was coming online, you could see it coming from space. It crushed pricing in the industry and it took years to absorb that supply.

Even with a business like CSL, one of the reasons why that's been such a phenomenal investment over the last few decades is because on the supply side of that industry, there are three players. There are unlikely to be many more because the barriers to entry are so high. And those three players have been rational about expanding supply to meet demand. We don't back ourselves to pick trends because you risk thinking the same way as everyone else and it can be difficult to make money that way.

GH: Your fund doesn't have what you might call a dominant style, you don't argue for example for value over growth. But do you think that as a consequence, in the market we've had over the last few years where growth has run so strongly, that you distrust the very high P/E stocks, the really big growth stories?

EF: Yes but distrust is probably not the word I'd use. Jealousy is probably a better word. I'm a bit jealous of the things that we missed not going in early enough and riding the rerate in earnings. I think that broadly the market is pretty efficient and usually the businesses that are on very high multiples actually do have very good prospects. It's just that if you're wrong on a business on a very high multiple, it's a long way down, and a long time from when the growth investors start selling a stock to when the value investors start buying. A recent example is a business like A2 Milk: very well loved on a very high multiple, runs into some issues, and it's been a long way down from $20 to $6.

We talk about multiples, price to earnings multiples for example, but it's a shorthand way of comparing different businesses in different industries. You must be aware of its limitations, and it tells you nothing about the prospects of the business. It does tell you something about what the expectations are but it doesn't tell you whether or not those expectations are going to be right. If you look at a business like Afterpay, which we've never owned, people have been calling it crazily overvalued at a $2 billion valuation and a $10 billion valuation and now it's going to be taken over at a $39 billion valuation. So there's no shortcut for doing the work. You have to get into an industry, get into the business, try to understand it and then try to figure out what it's worth, rather than having a fixed mindset that high P/E is bad, high valuation is bad, because I think that can lead you astray.

GH: We talk about the reopening trade as we come out of COVID, although we haven't yet really reopened. Do you think that some sectors have been left behind while the market has been focusing on that?

EF: Yes. When you are searching for stocks to give an exposure in your portfolio, it can lead you astray and into a section of the market that's probably overvalued in the short term. I remember last year in November, we were getting all this efficacy data on Pfizer and Moderna and the markets were rallying because it was so good. I was getting brokers sending me emails with lists of reopening stocks, here are

the ones that we suggest you buy. It was everyone crowding into the same ideas.

It was looking silly in terms of valuation for a business like Qantas. We've owned Qantas for a number of years, unfortunately rode it all the way down, then rode the recovery backup. So, when it got to about $5.50 in January or February this year, you might say, well, the share price was $7 pre-COVID so it has further to go. But while COVID is not the death knell of the business, we know that it's not been a good thing for airlines, the valuation really got ahead of itself. So we sold that ‘reopening trade’.

I think the segment of the market that had really been left behind at that time was retail especially bricks and mortar retail. You would never have predicted in March last year that retail was going to be one of the best-performing beneficiaries, but these businesses had phenomenal numbers, they generated a ton of cash in the 12 months. We're all in lockdown and spending money to get the dopamine hit of the postman come over. Retail is a business model that doesn't actually have very high cash needs, which means the balance sheets of these businesses are great, and they're probably going to pay that back out to shareholders.

We were able to pick up cheaply businesses like Nick Scali at $9, which is growing its store rollout by 40% over the next few years. So even if there's an elevated COVID element to their earnings right now, we think that they can absorb that with store growth rollout. Businesses like Premier Investments, with Solomon Lew one of the best retailers in Australia, and Wesfarmers as well. You know Wesfarmers was never hugely sold off or hugely cheap but Bunnings, Kmart and Officeworks is a suite of the best retailers in Australia. So the exposure you want is to these really good businesses that aren't a reopening trade. That's where we've been seeing value.

GH: Let’s focus on some stocks that have done well for you recently, such as Mineral Resources, Reece and PWR?

EF: The question is where to from here. PWR is a Gold Coast-based owner-managed business, and the guy that runs it was a mechanic who many decades ago decided he could make the best radiators in the world. And now he supplies every Formula One team with their cooling systems. It's quite incredible. I think it's a brilliant business that has further to run. Reece probably looks stretched on near-term valuation metrics on 44 times next year's earnings. They're Australia's largest plumbing wholesaler and they bought a plumbing wholesale business in the US three years ago and the market was pretty skeptical. But they've actually done a really good job. It's such a huge market In the US but it could trade sideways for a while.

Mineral Resources, I still feel like this business could still double although it's up about fivefold in the last 18 months and I know iron ore prices are falling. But in the next five years in iron ore, they want to get to 90 million tonnes. At that point, they'll be producing half of what Fortescue does and Fortescue is a $70 billion market cap company versus Mineral Resources at $11 billion. So leaving aside price, the iron ore volume expansion story alone is offering considerable upside.

GH: Is there a company that the market is completely under estimating, one that you can't understand why the market is missing?

EF: I can think of a few stocks that haven’t worked in the way that I would have hoped. But one thing the market is potentially underestimating is the wave of cash that is coming back to shareholders over the next 12 months. It's quite unusual to see the economic strength that we've seen across the board like it was for the last 12 months. Usually, you've got one part of the economy letting the side down whether it's banks or the mining or industrial businesses or the Aussie consumer, but everything has been firing.

So, all these businesses are sitting on piles of cash. Over the last six months there's been an unwillingness to pay that out to shareholders because of the uncertainty of COVID. And now that we've got vaccines that we know work and we can see the finishing line in sight. Maybe not this reporting season because we're now locked down again and maybe another excuse to hold the cash, but over the next 12 months, I'm expecting a lot of that cash to be paid out to shareholders.

And not only does that support the market because a lot of people just reinvest those dividends but it's a good thing. The market has looked pretty expensive in an absolute sense for a number of years, but in a relative sense, relative to a cash rate of 0.1%, the fact that the Australian market is yielding 3.5% in dividends is very attractive compared to what you can get with your cash. So that relative argument actually makes equities look fair value when looking at it through a different lens.

GH: A couple of questions about your own business. What does being part of the Magellan Group bring to an Australian equity manager?

EF: John Sevior founded Airlie about a decade ago. He'd been working at Perpetual but he wanted to run his own business, but he found after a number of years that more and more of his time was being taken up by non-investment hats that he had to wear – compliance, risk, legal, all the stuff that is increasing in our industry. And it was a real impost on our time as a small business. Magellan brings world class capabilities to the non-investment side, so we let

them wear all of those hats and we just focus on investing which is what we love doing.

And the other angle is the Airlie Australian Share Fund which has now been running for three years. Prior to that, we were an institutional-only business since 2012. We run over $9 billion of money for institutional clients, but the Airlie Australian Share Fund is a retail offering. And in order to access the retail market, you need the distribution and marketing that Magellan brings to the table. That would have been quite difficult for us to do on our own.

GH: And Magellan also allows investors to access funds in both listed and unlisted form.

EF: Exactly, and that cannot be underestimated. My friends and family who invest in the Fund all own the listed version. It's just so much easier. You can buy and sell it like any other share. The previous element of a premium or discount that came with a listed investment company was unfair either to existing investors or future investors, depending if it's at a premium or a discount. The single unit structure means you're basically entering at NTA.

GH: Yes, it's been a fantastic development. Final question. Are you tired of answering questions about inflation when nobody knows the answer?

EF: You've worded that perfectly, that question encapsulates exactly how I feel about the matter. The short answer is yes, I think everyone's tired about talking about inflation. I understand why the debate's happening, because the markets are only attractively priced in a relative sense, so the debate is around if that cash is right or wrong. If the cash rate is wrong, then the market valuation is wrong. But I think it's unknowable.

As an investor, you need to separate your stock-picking skills from your honest assessment of yourself as a macro investor. I think I'm a good stock picker. I've got enough of evidence of that but I have no evidence of whether or not I'm a good macro investor. Probably not. So you've got to make sure that you're not taking big macro swings with your portfolio because if you get them wrong and it is a different skill set, it can really overshadow the power of your stock picking. So we try to make sure that we're not positioning our portfolio in a way that is strongly positioned for this inflation narrative, because we don't know the answer. So I am sort of sick of inflation because it's this year's narrative. Next year it will be a different narrative.

Emma Fisher is Portfolio Manager at Airlie Funds Management, the Australian equity manager within [Magellan Asset Management](), a sponsor of Firstlinks.

Andrew Lockhart, Metrics Credit Partners: Corporate loans as an income alternative

21 July 2021

Loans to corporates were the traditional domain of banks, but as investors look for income alternatives to term deposits, funds have combined hundreds of loans into a single structure to create a diversified investment.

Andrew Lockhart is the Managing Partner of Metrics Credit Partners, a non-bank lender to Australian companies managing $9 billion across a range of listed and unlisted funds.

GH: Can you give us a short introduction to Metrics Credit?

AL: We launched our first fund in June 2013, starting with three partners, and the business now runs about $9 billion in assets under management with close to 80 employees. We directly originate loans to companies to support their activities to deliver good returns for our investment clients.

GH: Let's start with the product most of our readers might know, the two listed trusts, MOT and MXT. There's an ongoing debate about the relative merits of LICs, LITs and ETFs. Why do you believe the closed-end structure of a LIT is better for your asset class in the listed space than an open-ended Active ETF?

AL: Both can coexist but we want to create investment products that cater to individual investors' risk, return and liquidity requirements. The attractiveness of the listed closed-end structure is that companies need to know that the lender has committed capital that will not be withdrawn in difficult market conditions.

Consider the context of a large corporate client with a revolving loan facility, which they can draw or repay under a funding facility, or a company that's completing a property development project. They must know that when they submit the funding request, the lender has the capital and can provide the funding. So having that source of funding that is not subject to redemption risk gives our borrower

clients confidence when they deal with Metrics. As a result, we gain access to better quality lending opportunities than we might otherwise.

GH: And while LICs and LITs have come in for a lot of criticism, in your asset class, it's not easy to liquidate a corporate loan to fund a redemption in the same way as a fund holding an ASX 200 company.

AL: Exactly right. They are private loans so they can't be bought and sold over an exchange. With an ETF, there is a market maker that has the ability to buy and sell the assets of the fund, creating liquidity for investors. In our asset class, other lenders that are sitting alongside us providing funding to companies are often banks, and there's not a market maker that buys and sells loans to different companies to create liquidity in short periods of time.

The investor is able, hopefully, to achieve a premium return as we are lending for say three or five years. The margin and the fees to the company are higher than a short-term exposure. The investor receives a premium or pick up with the flexibility to buy or sell those units at short notice on the stock exchange on a daily basis if they wish.

GH: The credit you provide is corporate loans or private credit to unrated borrowers. What has been your default and loan loss experience over the years?

AL: Over the eight years since we established Metrics Credit, we've completed lending of close on $15 billion and in excess of 450 individual loan transactions. We have never delivered a loss to our investors. We've had four companies where we've had some form of restructuring or credit management associated with those loans. But in each case, we've been able to manage our investors' exposure and exit from those loans without loss. Two of those four borrowers had a default but we worked through a process to ensure that our investor capital wasn't at risk of loss. The part of the capital structure bearing the most risk of loss is equity, and so shareholders in those companies and those projects suffered a loss but we as a lender did not.

And that's an important feature of where you sit in the capital structure, together with the benefits of corporate insolvency laws that protect the interests of a secured creditor. We're always focused on the ways we can exit our exposure to ensure we can get our investors' money back if we need to.

GH: The test is when you have a severe stress event. How did the portfolio perform in the depths of COVID, say in March 2020?

AL: Credit to the government and the regulators for the support they provided. If you had asked me in March last year, I thought we were facing rising unemployment, declining asset prices and defaults. But the combination of strong management responses, government packages and the Reserve Bank lowering interest rates and supporting liquidity all helped economic activity.

Obviously, for a lender, there's no joy in seeing companies struggling. The government response facilitated the retention of employment and companies weathered the storm, but equally, companies raised equity capital. While that destroys value for existing shareholders, as it dilutes equity, fresh equity capital on the balance sheet reduces risk and gives the company liquidity.

We've seen similar events in other cycles as a lender. If credit quality or market conditions deteriorate, a lender can encourage a company to sell assets to repay debt, or maybe raise equity, while a lender is also conscious of preserving a going-concern value. Over the last year, we've maintained a strong discipline in lending to around 190 individual companies with income and capital stability for our investors.

GH: You regularly report the Net Asset Value (NAV) of your listed funds to the exchange. How do you come up with that number when none of your assets are listed?

AL: Investors need confidence in the NAV of our funds and the governance structure that oversees it. We have an independent RE (Responsible Entity) and a trustee across our funds who are responsible for the oversight of our activities. We also have an independent international accounting firm to test the market value and the portfolio monthly to determine whether there's any risk of credit loss or impairment that would be a reduction to the value of the portfolio.

These are not traded loans so they're generally held to maturity. Based on the credit quality of the borrower and the tenor of the loan, we can derive a market-based price. If there is a situation where a borrower might default or we are unlikely to recover the full value of our loan, then that impairment charge is immediately reflected in the carrying value. We're confident in our processes and we lend to less than 25% of all the transactions that we see.

GH: So I assume the first day or week that you fund a loan, it's in your valuation at say, $1, and if you have a three-year loan to a corporate who continues to service its payments, does that stay in the valuation at $1 or does it change according to the way credit spreads change in the traded market?

AL: It will change. Some of our funds are daily mark-to-market, but one thing to understand about a loan is that you don't get a value greater than 100 cents in the dollar. A loan can be voluntarily repaid by a borrower at any time at par, that's the best you will get. It's not like a bond, you're not going to get $105. We don't hold all of the assets at 100 cents in the dollar as we deduct from that the risk around

potential loss. Our reported accounts go through 'expected credit loss testing' on a weekly basis. But if a borrower is performing, and the margin we are receiving is commensurate with the margin and the fees currently charged to similar quality borrowers, then it will be held at $100. In our asset class, the underlying loan assets are all floating rate. If interest rates rise, then it will flow through to a higher total return to an investor.

GH: You also have a suite of unlisted funds and I'm wondering about the relationship between the listed and the unlisted.

AL: One of the things that we don't have in the listed fund is the ability of a market maker to trade an ETF, but our wholesale unlisted funds do have the ability to buy the listed funds if there is a dislocation in the market price. We provide a daily NAV and the listed funds should trade at or around the value of the NAV, but if there's a material discount, it's a signal that investors are looking for liquidity, and our wholesale funds can take advantage of that.

What we're trying to do is create options for investors. Some investors don't value daily liquidity on the stock exchange, they don't want to buy and sell, and they don't want to have the risk of secondary market trading impacting them, so they stay in the unlisted fund where the units revalue at the NAV. Those who want daily liquidity and have the capacity to withstand the volatility of the ups and downs of the secondary market trading might want to go into the ASX listed fund. We're agnostic.

GH: You recently bought about a billion dollars of loans from Investec. Can you tell us more about that transaction, the benefits for investors and how you bedded down the investment?

AL: Late in 2020, Investec was seeking to withdraw from the Australian market. We approached them to acquire that portfolio of assets, initially around $1.3 billion. We spent several months on detailed due diligence to check we were comfortable with the credit risk and that the returns would be good for our investors. There were some assets we were not comfortable with, but we were successful in acquiring around $1.1 billion. They are now in our funds, enhancing the liquidity and returns to investors. As we were not doubling up or increasing exposure to existing borrowers, it also gives greater levels of diversification.

And it also expanded our relationships with some corporate borrowers and gave us access to a part of the market that we were not previously lending to. We raised money from our institutional investors and a capital issue for MXT raised close on $200 million to finance the acquisition.

GH: It seems like a large amount to absorb into your existing portfolios.

AL: It was a combination of raising some new capital and using existing liquidity. While we were negotiating, we started to build up some cash reserves to make sure that we had the capital. We had also received funding proposals from banks that were willing to support the acquisition. So we knew we had funds available.

GH: We hear a lot about ESG (environmental, social and governance issues) in equity markets but how does it play out in private debt markets?

AL: It's a major component of our assessment and risk analysis. For instance, recently we surveyed all companies in our portfolio to understand what they were doing around their environmental and carbon emission reduction strategies. We now have data across our portfolio with detailed insights into how companies are managing, monitoring and seeking to reduce their emissions.

Corporate governance and transparency are also important. There are industries that we don't lend to based on a negative screen for either environmental or other social reasons. In fact, we are becoming more confident in sustainability-linked financing, especially around the capacity of third parties to independently verify and confirm that companies are achieving and delivering on their sustainability KPIs. We're seeing loan agreements with targets over the next three to five years, and if they deliver against those KPIs, then we might lower the interest margin. Some independent third parties have the resources and the capability to monitor and report back to a lender.

Metrics Credit Partners is a sponsor of Firstlinks.

Jeremy Grantham, GMO: The coming day of reckoning

2 June 2021

Jeremy Grantham has seen it all before, with bubbles every 15 years or so. The higher you go, the longer and greater the fall. You can have a high-priced asset or a high-yielding asset, but not both at the same time.

Jeremy Grantham co-founded GMO in 1997 and is a member of its Asset Allocation team, serving as the long-term investment strategist. He was interviewed by Kunal Kapoor, CEO of Morningstar, at the Morningstar Investor Conference Australia on 2 June 2021. We previously featured Grantham's pessimistic outlook on the market in 'Waiting for the Last Dance'.

JG: Having high-priced assets is great for retirees and old folks like me, for selling off my assets, but for everybody else, it means you compound your wealth more slowly. And if you don't have any wealth, you pay twice what your parents paid for a house, you pay twice for a portfolio in the sense that you get half the yield. It's a fairly miserable world so I welcome lower asset prices which I'm confident will come from these very high prices, even a modest retracement back towards the last 100-year average. If it went back halfway, there's a major bear market.

And the other thing we have to watch is, if you're going to have a bubbling market, make sure you only do it in one major asset class. Don't pull a Japan. Japan had the biggest bubble in history in land and real estate, bigger than the South Sea Bubble in my opinion. It also had the biggest equity bubble of any advanced country. Pulling two at the same time means 32 years later, their land is not back to where it was in 1989, and the stock market is not back in nominal dollars to where it was in 1980.

And that's a perfect example as the higher you go, the longer and greater the fall. Japan had never sold at over 25 times earnings before and at the time, it was 65 times. That's a pretty hefty new high, from 25 to 65.

And the same in 2000. We had never sold over 21 times earnings and then the tech bubble took us to 35 and 10 years later, we were selling at a lower price. And that's how it works. You can't get blood out of a stone. You can have a high-priced asset or a high-yielding asset, but you can't have both at the same time.

KK: What do you think some of the triggers might be that could lead to this reassessment of the valuation of different asset classes?

JG: Well, they're still arguing about what caused the 1929 crash. We have not been good at identifying causes and it may be because there is no traditional pin to pop the bubble. The market hits its all-time high when optimism is at an absolute peak. And the following day, is the second-most optimistic day in history, but it's a shade less optimistic than it was yesterday, and the price begins to fall a little bit.

It won't take bad news, it won't take a thoroughly bad economy. It will take a perfectly good economy and perfectly optimistic outlook, but a little less than it used to be a week ago, a month ago. And in 2000, we saw the really optimistic crazies, the pet.coms, peel off in March of 2000. The rest of the market shrugged them off as crazies and the market kept rising, and then they peel through the growth stocks and finally they shot Cisco which for eight seconds was the biggest company in the world by market cap.

By September, the 30% of the market that had been growth was down 50% but the S&P was unchanged. The rest of the market had continued to rise by 15%, and then the termites, the optimism termites or the pessimism termites, would be a better description, finally got to the balance of the market and the whole 70% rolled over and dropped 50% in two years.

What do we see this time? The super crazies are anything to do with electrification, EV for sure. Tesla is the king of that route, and the SPACs (Special Purpose Acquisition Companies) and the intersection whether EVs or batteries and so on. It was perhaps the most outstanding degree of enthusiasm and the SPAC index is down 30%.

KK: So amidst that big picture where we're in a unique time with unique asset prices, interest rates low, debt high, debates around whether inflation is going to be real or not, are there any pockets that you think are interesting from an asset class perspective? Where you think people can earn a decent return, or do you feel you're going to have to just be defensive for a long time?

JG: It's closer to that. 2000 was brilliant, though. Bonds were incredibly cheap, TIPS (inflation-linked bonds) yielded 4%, real estate sold below replacement costs. You don't want to pull a Japan, and we tried to in 2008. We had a genuine housing bubble in America, a three sigma, one-in-100-year event, and it sucked the equity market with it. The housing market went all the way back to trend line and it took the S&P down 50% with it.

And those two combined packed a much bigger punch to the economy than had the tech bubble in 2000. And 2008 also had oil and commodities spiking in 2007 so they inflicted quite a lot of pain on consumer income and that made the recession even worse. This time, real estate is suddenly pretty bubbly in almost every interesting market in the world. I have to say, notably including Sydney, but also Vancouver, London, Paris, New York, San Francisco all over, and our housing market is up 15% in the last year. You can't have an asset class like housing, where the house doesn't change and you're just marking it up in real terms, year after year. Eventually, there'll be a day of reckoning.

And remember, the higher the multiple of family income, the longer and the bigger the pain is likely to be based on Japan and on the US. So real estate almost everywhere on the planet has doubled in price and halved in yield. The bond market, as Jim Grant would say, is the highest in the history of man. We have records going back to the Babylonians, and there's never been these kinds of negative real rates. And then it comes to equities, where it isn't so much global as the US.

The developed world is merely overpriced, no big deal on its own, but the US is heroically overpriced and emerging markets is actually fairly cheap. Then within the structure of equities, value managers have had a brutal 11 years. It was the worst 10 years in history for value versus growth, and then last year was by far the worst single year. Value is certainly as cheap as it has ever been against growth, and there are signs over the last few months that it has shifted.

If you look at the intersection of these two ideas, emerging markets and value, I have complete confidence that if you bought the intersection - cheap emerging market stocks - then you would get a perfectly handsome 10- or 20-year return. And I am pretty darn confident that you will not get a handsome 10-year return from say the S&P 500 or NASDAQ. NASDAQ peaked two months ago, and is now up 5% versus the S&P's 12%.

Remember, it has a higher beta. When high beta stocks start to underperform, you want to watch out. In 1929, the flaky, junky high beta stocks underperformed the whole year so badly that they were down year-to-date the day before the crash. They did the same in the Nifty50 era of 1972. The S&P was up 17% while the average big board stock was minus 17, nice symmetry. And then in 2000, as I said, all the growth stocks went down, and the rest of the market went up for eight months. And this time, my guess is the super SPACs peaked in January, the NASDAQ peaked in February, and maybe in a few months, the termites will get into the rest of the market.

KK: I want to ask you a simple question around the surge in commodity prices where any significant commodity is at multi-year highs. What's your view and what's going on and is it sustainable? Obviously for investors in Australia, it's a very important topic.

JG: I think there was a paradigm shift. We had gone from 100 years of irregularly falling prices, yes, they go up in World War One and World War Two and the oil crisis, but in between they kept coming down. So over 100 years, they lost 70% of their real value. Then from 2000 to 2008 and then in 2011, prices bounced up without anyone getting too excited, mainly due to China. That created a new era where we've kind of entered the end game, where instead of prices routinely falling in the long term, some will rise, some will fall, some will be flat, and you just have to get used to the fact that it's not a tailwind (for the economy) any longer.

There is no way copper will not rise hugely from here because of the electrification of everything. And that goes for cobalt, that goes for lithium, and all of the metals except iron and aluminium are really scarce. We've done a pretty good job over 200 years of mining out the really high-grade ores everywhere. There's a lot of aluminium, there's a lot of iron ore, you may have squeezes like we have today from time to time but in the end, there's plenty, but everything else is really, really scarce.

You have to be reconciled in the long run for a different world of commodity prices, but what that means for the next two years, I leave to other people.

KK: A lot of what you've been laying out (in the past about climate change) obviously makes sense if you're overseeing a large pool of money and you're allocating assets and you have access to all kinds of information and data that allows you to make some of these decisions. What do you think an effective decision making and implementation framework might be for a financial adviser or an individual investor who's starting to think about these issues? If they want to make a shift in their portfolios to reflect valuations and climate change and some of its effects. How can folks individually start to make a difference?

JG: They can make a difference by buying climate change funds. I'm happy to say GMO has a pretty good one. ESG funds, where many reputable firms have them, that would make a difference. It would be good if we had a better rating on all the funds voting records to see how green they are.

Let me just say a word about the Grantham Foundation because we have a completely different investment approach. We decided that American capitalism seems to be past its prime, a little fat and happy, not aggressive enough. There's only half the number of people working for firms one- and two-years-old as there were in 1975. So we're losing some of our dynamism, but there is one thing where the US is still exceptional and that is venture capital. Venture capital is really attracting the best people these days, they

don't go to Goldman Sachs to write algorithms, they go into venture capital or to start a new firm.

Venture capital is not like private equity. It's not institutional investing. In the end, we have to admit we're playing a cosmic poker game. We (GMO) are trying to beat the other players, and it's fun, but we're not really creating value. Venture capital is, we're causing firms to exist that otherwise would not exist. We're raising money for them, and in some cases, some of us are giving good advice to them. But America does that very well and we decided in our Foundation to go for broke. We are aiming to put 70% of everything we have into early-stage VC, of which half is in green early-stage VC, and we have our own team doing that. Thoroughly exciting Boston is a great place to do that, we started more new ventures last year than San Francisco.

It's just amazing what new technologies are out there. Microbes that will sequester nitrogen in the ground. Batteries that will last twice as long and weigh half as much and won't burst into flames. The list is completely endless. And the challenge is endless, so this is going to be where all the opportunities are.

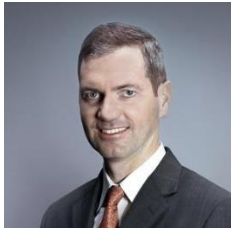
The FANG-type companies are what separates the US stock market from the rest of the world, and not so much the P/E as the earnings. Most of the outperformance of the US market in the last 10 years has come from extra earnings, and over 80% of those extra earnings have come from this handful of FANGs. They have sprung out of the venture capital industry. They are a classic demonstration of that pool of venture capital 20 to 50 years ago, these are some of the winners that have become global giants, bone crushing in their competence and competitive spirit. And I think that that will continue, and it will be a true advantage for the American system.

This is an edited transcript by Graham Hand.

Ted Maloney, MFS Investment Management: Global search for short-term losers and long-term winners

3 February 2021

Active managers need to know what factors are distorting asset prices. This interview with Ted Maloney, CIO of MFS, explores how much of 10 years of growth has been pulled forward and the impact of Reddit users.



Interview with Ted Maloney, Chief Investment Officer, Global Director of Research and Equity Portfolio Manager at MFS Investment Management. He has been with MFS since 2005.

GH: We’ve seen COVID accelerate global trends, with some companies compressing 10 years of growth into one year. What challenges and opportunities does this throw up for you as an active manager?

TM: The first thing most fund managers had to do is make sure they have their teams in place remotely and are able to do their jobs. It was fairly seamless for us given we are a global firm and we're used to spending time on video conferences working with our colleagues around the world.

On the investing side, there are industries that are advantaged or disadvantaged, and what is most interesting is where there is a mispricing. We have developed a 2x2 matrix with long-term COVID winners and losers on one axis and short-term COVID winners and losers on the other, and the best opportunities are in short-term losers and long-term winners. That’s where we can uncover value. We know some are overvalued but others really will be worth what they're trading at today. It’s our job to sift through knowing there are factors at work that are distorting asset prices.

GH: But there must be disagreement about which box different companies belong in.

TM: Well, our views will show up in our investments but, yes, we couldn't publish a document on the matrix because there's inherent disagreement in the team. A critical part of our process is making sure that we have a culture that allows for genuine disagreement. As we collaborate and debate to get to the right answer, one person's long-term winner might be another’s long-term loser.

GH: We’ve seen some extraordinary rises in stock prices, particularly in tech and in growth versus value. We seem to publish a new chart each week which shows how elevated the market looks and then a month later, it’s even higher. Where does MFS stand on whether the market’s got ahead of itself, or is it justifiable that the Microsofts and Teslas of the world are gaining from the way the world is changing?

TM: I'd say both. There are pockets of excessive exuberance and perhaps bubbles, but you tend to not be able to declare something is a bubble until after it's burst. While you can identify where you think a bubble might be expanding, there are also real businesses doing well.

The overarching reality is that monetary policy, particularly in the last year, is causing market distortions. Free money will find a home in assets, especially where the DCF (Discounted Cash Flow) will tell you that most of the value is in the outer years. So companies that have a story that they're going to grow until the end of time have done well. We know some are overvalued but others really will be worth what they're trading at today. It's our job to sift through knowing there are factors at work that are distorting asset prices. As long-term investors, it is a positive for our ability to deliver for our clients.

GH: You take a global perspective in your investing. Are you seeing pockets of success and a wide variance between different countries around the world?

TM: The home country of the big trends we were talking about is the US but there are certainly examples in every market around the world. In Australia, there are companies that have behaved exactly like some of the US companies. When we're talking about overall indices, it's the US that has been most impacted by the easy monetary policy and the resulting high valuations, but we do look for relative value comparing businesses in the same industry to others around the world.

GH: How much has the different impact of the pandemic around the world influenced your investing?

TM: Given that we are long-term investors, we're not sitting around watching the daily infection rates for each country for investing purposes. We do watch it closely for managing our own business and looking out for our colleagues in different countries. But we are watching the implications for specific companies, such as where they are paying extra to their employees and spending more on safety measures that will hurt near-term but will deliver for customers and for employees over the long term.

That's where sustainability investing is crucial in any market and COVID is a great test. Companies always like to say that they care about their employees and they care about their customers and they care about everyone. But when they're put into stress, you can see what they really care about.

GH: We know many sectors, such as online shopping, have done well in the last 12 months but do you think there are some sectors that are doing better than the market recognises and they look fundamentally cheap at the moment?

TM: The market tends to be good at pricing in what's happening right now. But one example is live entertainment, which is non-existent now but we think it will come back bigger than ever. While it's important in investing not to over-emphasise one's own perspective, I know that my price elasticity for the next concert where I feel safe will be extremely inelastic.

Another example that we debate is business travel versus personal travel. Most of us agree that personal travel experiences will come back stronger than ever, but business travel probably will not come back to its full strength.

What's overlooked in this discussion is the strength of a company's balance sheet. A company might be well-positioned for a COVID recovery in five years, but that's not much good if they're insolvent between now and then. We have the advantage of equity, fixed income and quant teams that are completely integrated and in moments of stress, for example, the credit analyst can give the equity analyst a different perspective.

GH: Do you have examples of themes where prices might have gone ahead of value?

TM: Well, obviously anything that you can consume from the comfort of your home has benefited greatly from COVID and many of those companies have executed well. Our job is to decide how much of 10 years of growth has been pulled forward as part of a permanent paradigm shift and how much will evaporate in a return to normal.

GH: We've seen an extraordinary week or two on the Reddit platform, with 'Robinhood' traders and a stock like GameStop. How strong are you seeing the influence of this new retail movement on the market, such as the ability of the combined impact of thousands of smaller investors taking on the might of Wall Street and the hedge funds in particular?

TM: If there was any doubt about their influence in the last year, it's undeniable over the last week. I think the root cause goes back to monetary policy and free money trying to find a home. At the same time, lots of people are sitting in their homes and figuring out what to do with their free money, and it's a dangerous cocktail. But we worry about what happens when the tide goes out and individual investors will be harmed.

We do not worry about imprudent risk managers, professional risk managers who are in a lot of trouble by being short excessively some stocks. They have exposed themselves to a coordinated attack by individual investors and there's some poetry to that, to be honest. We don't necessarily root for it but our job is to identify market inefficiencies and understand what short-term market actors are doing, and that gives us opportunity to invest for the long term.

What's a bit more subtle is that due to the short squeezes, full hedge fund books have been liquidated, including long positions, without regard for prices or their views on the stock. Our investment managers and traders are paid to understand the technicals of the market and when a company we like is now 5% cheaper due to a forced seller driven by short-term incentives, we can go in and buy that that stock because 5% has just been handed to us. We realise it could be down 5% tomorrow and another 5% the next day but if we understand the real value of the company, in the long term we will deliver for our clients.

GH: A platform like Robinhood publishes its turnover each day. Would a professional house like MFS watch that as an input to your own process?

TM: We examine all data that may be of use and available. If we're trying to understand why a company is, say, trading off sharply and we can't explain it for fundamental reasons, then we look for other market factors. In the last couple of weeks, we've paid more attention to the retail turnover data but I wouldn't expect that in six months' time various Twitter feeds will be included in our models. But we do need to adapt our process on the margin. Our job is to come up with creative approaches to discover value in the marketplace.

GH: It's hard to ignore the five big tech companies, the FAANGs, as they make up a quarter of the S&P500 and affect almost everyone. Do you have a view whether the tech titans are overvalued or are they just such great businesses that current values are justified?

TM: It's a company by company judgement. They are certainly highly valued and they are all excellent companies, so that's where the job gets hard. We ask how much growth do we need out of a given company to justify the valuation? In many cases, the answer is more than could possibly be justified by the current valuation.

We try to bring original insights to the analysis and regulation is something that we worry a lot about in this space. Regulators don't care much that a few hedge fund managers have been harmed but when it reverses, regulators do care deeply about the harm to individuals. There are platforms putting individual investors at harm and that will probably draw some regulatory scrutiny. The same is true across the tech and social media landscape as regulators increasingly become concerned about the potential harm in one form or another.

GH: With 300 MFS investment professionals around the world, what are some key principles to manage the culture and coordinate so many people?

TM: In this environment, everyone in our firm understands that if you're taking care of your colleagues not only from an investment perspective but also from an operational and personal perspective, then you can make sure you're also taking care of your clients. The main job of the leadership team is to set the tone and culture.

A big part of our process is making sure that we have an environment where people can strongly disagree with each other and bring different viewpoints in order to get to better insights. There's lots of different ways to create and debate different viewpoints, but a good foundation is having people with diverse backgrounds. Diversity is key to success and we work hard to get better at it and then importantly, we think that the companies that we invest in should do the same. They'll benefit their own clients and our clients as shareholders. And it's all part of being a sustainable investor to drive true long-term value.

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