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Editorial

Most investors love to buy stocks that others own, when what they should be doing is looking at ones that others ignore.

For instance, many large fund managers can't buy small or microcap stocks because they're too illiquid. They'll often stay away from stocks that have fallen dramatically in value because they'll get too many hard questions from asset consultants. And they'll shun stocks with serious ESG issues, such as oil and coal, because they either have ESG mandates or risk losing investors in their funds.

Investors can take advantage of these constraints on institutions to get an edge in markets. Here's a look at three strategies that can deliver market-beating returns.

Dogs of the Dow/ASX

In his 1991 book 'Beating the Dow', Michael O'Higgins outlined a strategy of investing in underperforming companies which he dubbed 'Dogs of the Dow'. The strategy involves buying the ten worst-performing stocks from the Dow Jones Industrial Average (DJIA) from the past 12 months at the beginning of the year, and then selling them at the end of December. O'Higgins added one caveat: the stocks selected should be restricted to only those paying dividends.

The rationale behind the strategy is that the ten worst performing stocks in a given year will have gone down so far in price that investors hate them. Anyone who could have sold them probably has, which can mean there are few sellers left. Fund managers won't want to hold onto these stocks at the start of a new year because they won't want to justify owning them to asset consultants and their investors. In effect, these managers can become forced sellers of the stocks. And because the stocks are so deeply out favour, they're often trading at cheap prices.

The reason for restricting the strategy to the DJIA is that large caps are more likely to have the financial strength to stay in business. Adding a further filter of investing only in dividend paying companies helps to ensure that the stocks have the financial health to pay out a dividend from their profits.

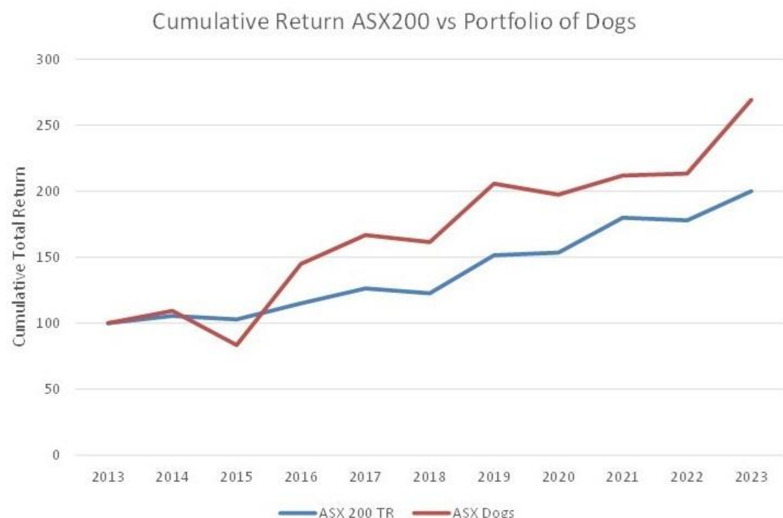
How has the strategy performed? Hugh Dive from Atlas Funds Management has tracked a 'Dogs of the ASX' strategy over the past decade. In 2023, the average equal-weighted return of Dogs from the previous year returned 26% versus the ASX 200's gain of 12%.

Dogs of the ASX in 2023			
Company	Industry	Bottom 10 in 2022	Subsequent Return in 2023
The Star Entertainment	Gaming	-52%	-65%
James Hardie	Building Materials	-52%	104%
Reliance Worldwide	Building Materials	-51%	50%
Xero	IT	-50%	51%
ARB Corporation	Consumer Discretionary	-50%	34%
Reece Limited	Building Materials	-47%	56%
Domino Pizza	Consumer Discretionary	-43%	-13%
Charter Hall Group	Listed Property	-40%	-1%
Seek	IT	-35%	26%
Downer EDI	Contracting	-34%	20%
ASX 200			12%
Average			26%
Dogs Beat the Index			Yes

Source: iress & Atlas FM

The best performers included James Hardie and Reece, which were sold down in 2022 on concerns of a US recession, only to come storming back last year as the recession never eventuated. Other gainers were IT companies which were hammered in the broader tech selloff of 2022, before bouncing hard in 2023.

Since 2013, the Dogs of the ASX have beaten the ASX 200 in 7 out of 10 years. Overall, the cumulative outperformance of the Dogs has been impressive.



Source: Hugh Dive, Atlas Funds Management

Hugh Dive admits there are few fund managers who would be able to run this type of strategy. They wouldn't be able to justify holding stocks with such bleak outlooks to asset consultants at the beginning of a year.

I would add another reason: it's psychologically hard, even for a fund manager, to hold onto stocks that have tanked. It can be easier to put them in the too-hard basket and move on.

For the enterprising individual investor, though, that can provide potential opportunities.

Tobacco stocks

Morningstar's Shani Jayamanne wrote a recent article on one of the best performing stocks of the past 100 years: Philip Morris. US$1,000 invested in the company in 1925 would be worth close to US$1 billion now. That's an annual return of more than 15% over that period.

Philip Morris is a US-based tobacco company. It's well known that tobacco has been a declining industry for decades. Smoking peaked in the US in 1961 and as its health issues became widely known, massive lawsuits against companies followed. Warning labels were slapped on products, governments restricted advertising of tobacco, and repeatedly raised taxes on companies.

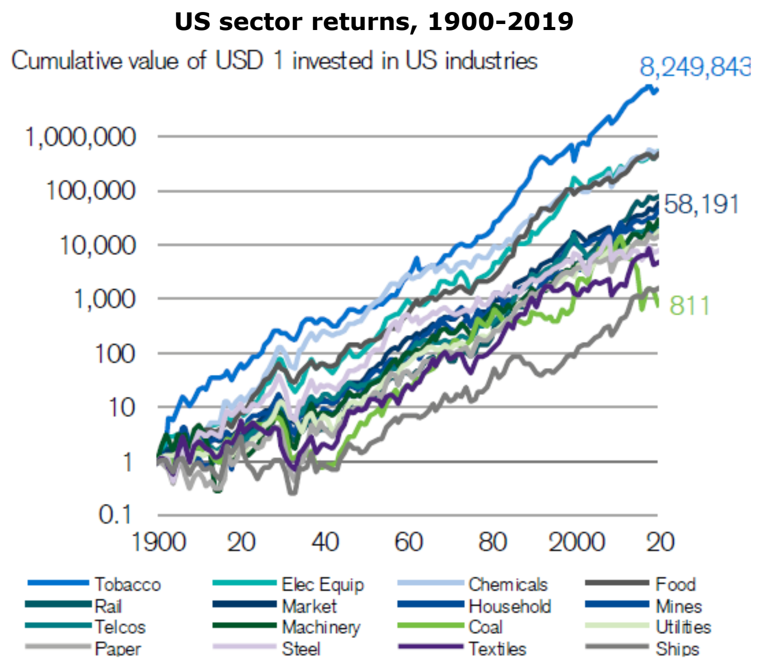
The question is: how has Philip Morris performed so well on the stock market given these headwinds? One of the reasons is that investors have largely stayed away from the stock, particularly institutional investors. They haven't wanted to be part of the lawsuits, health warnings and bad press that have accompanied Philip Morris along the way. Not to mention the rise of ESG in the past 20 years and the restrictions that's placed on funds investing in 'sin' stocks.

Consequently, Philip Morris has traded at cheap levels for much of the period. A low share price does a couple things:

- It raises the cost of capital for a company. The means that Philip Morris and other tobacco companies have had higher return hurdle rates when it comes to new projects. Put simply, it's restricted them from undertaking aggressive expansion. It's also reduced competition from new companies. That's limited industry supply and consolidated the power of existing players such as Philip Morris.
- It allows a company to buy back shares at cheap prices. Philip Morris has regularly bought back shares over the decades, and that' paid off for investors.

Another contributor to the performance of Philip Morris and other tobacco stocks has been their ability to raise prices to cover increased taxes on their products. With declining tobacco volumes, increasing prices has been critical to boosting earnings for these companies over time.

US sector returns, 1900-2019



Source: Credit Suisse

Small/value stocks

Many institutions are restricted from buying small and microcap stocks for liquidity reasons. Small cap stocks don't have enough turnover for these funds to establish meaningful positions.

It means there's less investor demand for these stocks. Not only that, but there are likely to be few broker analysts covering the stocks. And limited media coverage of the stocks too. All of this increases the chances that these types of companies will be neglected and cheap.

A well-known fund manager, Dimensional Fund Advisors (DFA), was founded in 1981 to take advantage of these gaps in the market. The founders were largely influenced by the work of academics Eugene Fama (aka 'The Father of Modern Finance' or 'The Father of the Efficient Market Hypothesis') and his colleague Kenneth French, who developed a statistical model of asset prices, and observed that two classes of stocks tended to do better than the broader market: small caps, and stocks with high book-to-price ratios.

DFA took these observations and formed low-cost funds based on them. The success of the strategies has resulted in funds under management ballooning close to US$1 trillion.

DFA certainly aren't the only firm to take advantage of small cap and value strategies to beat markets, though they're one of the largest and most well-known.

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In my article this week, I look at the rout in battery metal prices and the lessons for investors.

James Gruber

Also in this week's edition...

The major Australian banks have had a nice run of late as markets start to factor in a soft landing for the economy. But **Firetrail's Scott Olsson** believes that the market is overlooking some earnings headwinds that are likely to put pressure on bank share prices this year.

In 2022, the Federal Government introduced star ratings for aged care homes with the aim of providing simple, reliable information about the quality of care. Yet a new report suggests that instead of providing the transparency older people need to compare and choose an aged care home, the star ratings may actually lead them to choose a home that is delivering poor care. **Rachel Lane** reviews the report's findings.

Bitcoin has seemingly gone mainstream with approval for the first U.S. ETFs that can directly invest in the cryptocurrency. The question for investors is whether Bitcoin warrants a small allocation in their portfolios. **Peter Lazaroff** examines the pros and cons.

ASX REITs have been left for dead, some unfairly. **Airlie Funds Management's Jack McNally** sees Charter Hall Group (ASX:CHC) as a case in point. He says the company has a stellar track record and its 2024 profit guidance is conservative and likely represents trough earnings. Combine that with a large discount to asset value, and the stock appears great value.

With markets having gone gangbusters over the past six months, it's no surprise that the well-known Fear & Greed Index, used to gauge the current mood of the market, shows that it's now close to 'extreme greed' mode. **Jonathan Daffron** says investors are underpricing risk and it's time to get cautious.

Tony Dillon has been doing some light holiday reading by boning up on Albert Einstein's Relativity Theory. Rediscovering his 'inner physics geek', Tony sees several metaphorical parallels between the theory and the world of finance.

Lastly, in this week's whitepaper, **Magellan** looks at global infrastructure investment and the positive prospects for utilities.

Lessons from the battery metals bust

James Gruber

A few years ago, I bumped into an acquaintance who told me that he'd quit his job as a lawyer because he'd made a killing in lithium stocks. He had most of his net worth in these stocks because he was sure that he'd make a lot more money – enough to retire on.

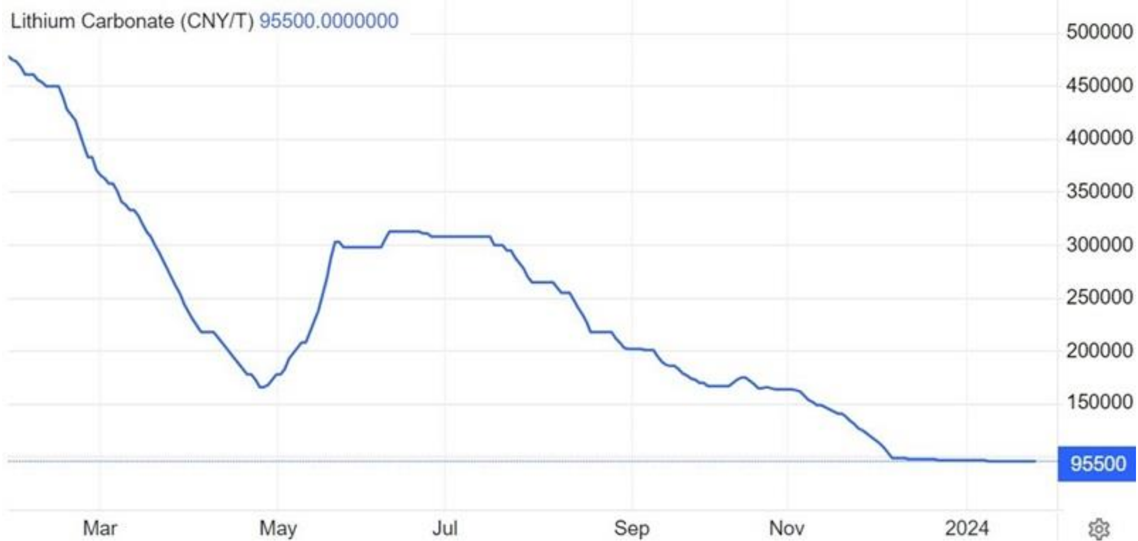
At the time, alarm bells rang in my mind because:

1. There's no sure thing in markets.
2. Putting most of your net worth in commodity stocks is rarely a sound strategy.
3. Having been a commodities analyst, I knew that the mining sector was extremely volatile and tricky to get right.

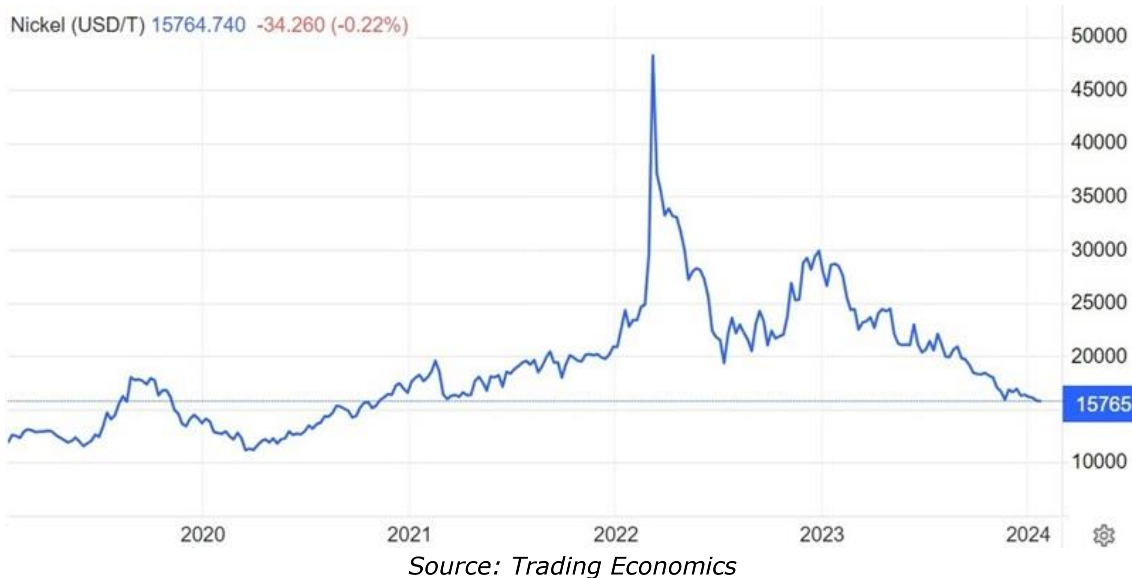
The recent crash in battery metal prices has caught many, including this acquaintance, by surprise. Billionaires such as Gina Rinehart, Andrew Forrest, and Chris Ellison are nursing losses. Some of the companies who'd previously boasted of never-ending industry riches are now struggling to survive. Investment bankers who'd pumped up these companies are having to explain what went wrong, while they've walked away with tens of millions in fees.

What's happened with lithium and nickel isn't unique. It's a classic story of boom and bust that's occurred many times, both in the commodities space and in other sectors.

It's worth examining what went wrong with battery metals and what lessons investors can take away from the episode.



Source: Trading Economics



Source: Trading Economics

The capital cycle

What's gone on is best explained via a framework developed by London-based hedge fund, Marathon Asset Management. Called the capital cycle approach, it's the basis for two books by well-known financial writer, Edward Chancellor (Capital Account and Capital Returns).

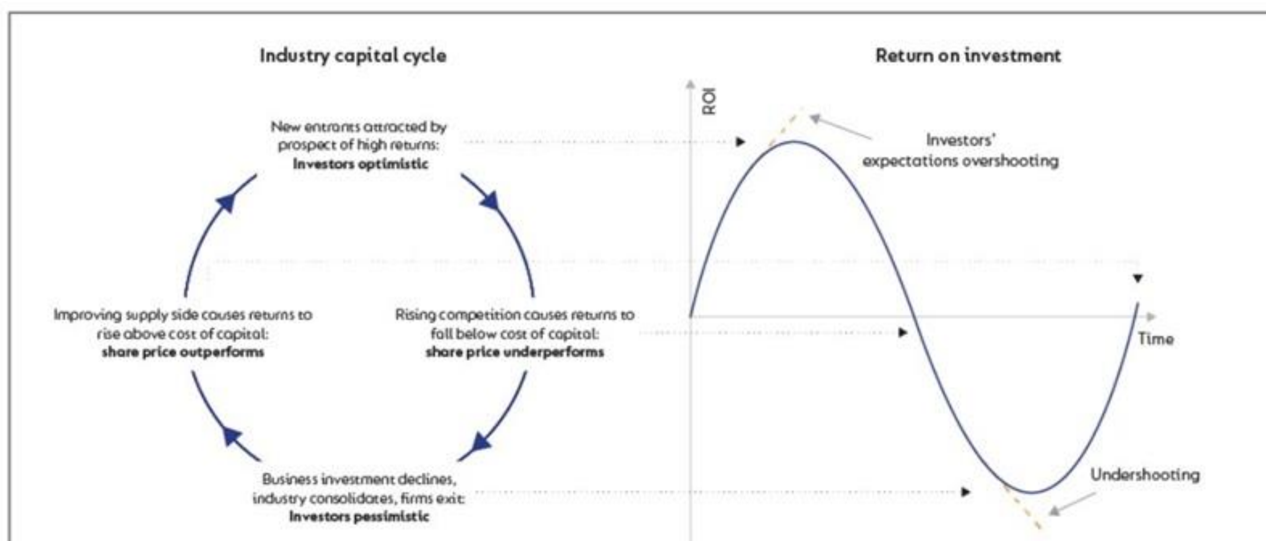
What Marathon does is apply Professor Michael Porter's famous 'five forces' competitive strategy to the stock market. Porter said that companies don't exist in a vacuum and that their fortunes are determined by the activities of other businesses. He outlined five forces which influence a firm's strategic position: the bargaining power of suppliers and buyers, the threat of substitution, the degree of rivalry among existing firms, and the threat of new entrants. Unless a business is protected from these forces, then competition will "drive down the rate of return on invested capital toward the competitive floor rate of return".

Marathon has taken Porter's theory into the world of investments. They suggest that in a free market, high returns on capital or the potential for growth will attract new investment. The stock market can accelerate this process because if a company's shares sell at a premium to the replacement costs of the firm's assets, then there is a strong incentive for management to increase their spending on new or existing projects.

High stock prices not only influence decision making in public markets, but private ones too. Private firms, observing similar businesses selling at high multiples of replacement cost, may also decide to increase business investment. Venture capitals and investment banks can spur this on by helping to finance this investment. They may also assist new firms to enter the fray. All of this drives up supply in the industry.

Marathon says that high returns on capital should act as a warning sign, but companies and their managements often extrapolate these returns far into the future. They assume that their prospects are bright, and the returns are assured. And they're often surprised when the competitive forces that bring on new supply in the industry act to lower returns.

Marathon suggests that professional investors, who often take their cues from company management, are also liable to be caught wrong-footed.



Source: Edward Chancellor, Capital Returns: Investing through the Capital Cycle: A Money Manager's Reports 2002-2015

The classic bust

What's happened in the lithium and nickel markets mirrors the capital cycle described above.

In lithium, prices soared almost 13-fold in 2021-2022 as demand for electric vehicles (EVs) took off and supply couldn't keep up. Understandably, prices of lithium stocks exploded higher as investors bought into the 'multi-decade growth story' of EVs.

With stocks prices way above replacement costs, management at lithium companies decided to expand supply, either by boosting existing mines or bringing on new mines. Private firms, seeing the higher spot prices and share prices of competitors, also decided to increase supply to meet the greater demand for lithium.

Investment bankers raised new capital for public lithium firms to help build out new capacity. They also IPO'ed lithium companies, which brought more capital and supply into the industry.

At their peak, spot lithium prices were more than double the cost of production for companies at the most expensive end of the cost curve and about 3 times those at the lower end.

The result? The supply of lithium increased by almost 40% last year, as:

- Africa brought on supply at such a pace that it surprised everyone.
- Hard rock production rose in Western Australia.
- New salt lake sources were unearthed in China.

At the same time, demand for EVs softened in China, as the economy there struggled to rebound after Covid lockdowns.

Consequently, lithium prices and stocks cratered. Companies that were aggressively expanding supply are now pausing production and closing mines. Some are struggling to refinance loans. And others are pleading for government help for the industry (got love it when billionaires ask for handouts). There's also increasing talk of takeovers and industry consolidation.

Investment bankers that once forecast industry supply deficits are now predicting surpluses, perhaps for the next five years. IPOs in the sector have dried up as some firms struggle to make ends meet.

Lessons for investors

What's happened in battery metals isn't unique. Previously, the Buy Now Pay Later industry went through a similar boom and bust cycle.

Here are some of the lessons from the lithium and nickel rout:

- Everyone focuses on demand in an industry when supply is often more important.
- Be sceptical of any sector that's described as a structural growth story, especially in the commodities space.
- Beware of a spate of IPOs in one sector. It can signal that more money will enter the industry, driving up supply, and potentially driving down returns.
- If investment bankers are pumping up a sector, run the other way.
- Don't blindly follow billionaires into investments. These people are often betting just a fraction of their net worth and won't get hurt if it doesn't turn out.
- With commodities, when spot prices are well above the costs of company production, it will almost inevitably lead to increased supply.
- When company management constantly talks up their share price, or bags short sellers, it's a red flag.
- There is never a sure thing in markets – spread your bets accordingly.

Where to from here?

The lithium and nickel markets are now working their way through previous excesses. As the capital cycle diagram above suggests, the end of a cycle is normally characterized by business investment declining, firms existing, industry consolidation, and investors being pessimistic. That describes exactly what's currently happening in these markets.

The industry is starting to get the attention of more fund managers. At a luncheon this week, Tribeca's Jun Bei Liu described lithium stocks as 'interesting' given recent developments of production cutbacks and consolidation. Other funds such as Pella Asset Management have recently invested in the sector. Pella believes that lithium demand will exceed supply by 2025 as EV sales grow and there's a shift to larger EVs, while lithium supply may struggle to ramp back up.

Time will tell, though we're undoubtedly getting closer to the end of this cycle.

James Gruber is an assistant editor at Firstlinks and Morningstar.com.au

The case against owning Aussie banks

Scott Olsson

Financials are a topical sector among investors as we go into 2024. Following a series of moderating inflation prints and a more dovish Fed, the market has focused on the negatives of lower interest rates for the insurers, and the positives of a soft-landing scenario for the banks. We believe both views are overly simplistic and overlook some less obvious earnings dynamics. Below we outline why we remain firmly overweight the insurance sector and do not hold any of the Australian major banks in our High Conviction Fund portfolio.

The insurance trade is not over

The general insurers followed up a strong 2022 with further material outperformance over the first ten months of 2023. However, the sector struggled in November and December as bond yields fell 50 basis points or more across most major developed markets. We hold two of the three major Australian listed general insurers, QBE Insurance and Suncorp, and still see significant upside in these names over the coming years.

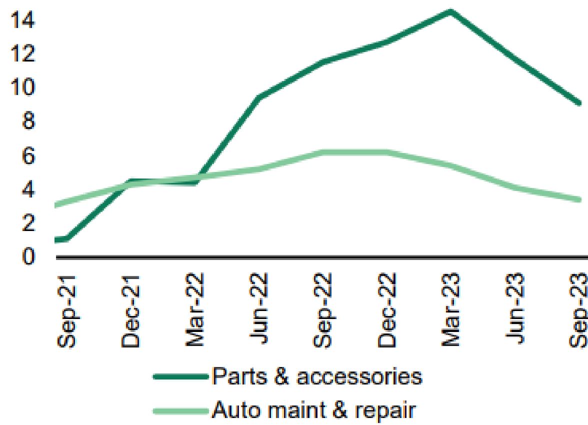
We believe the view that no upside remains in the insurers due to the peak in the interest rate cycle is overly simplistic for the below reasons.

1. Lower inflation is a forgotten positive for margins

If interest rates are to come down meaningfully, it will be because inflation is also moderating steadily. CPI and PPI measures linked to Motor and Home claims are already showing some improvement, which can be expected to continue if general inflation is normalising.

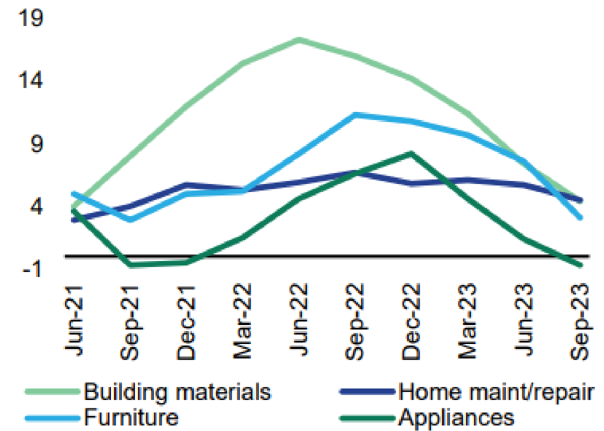
Due to the lagged nature of revenues for insurance, margins tend to undershoot as inflation rises, and overshoot as inflation falls. The market is completely ignoring this dynamic at the moment.

Figure 1: Motor inflation measures (%)



Source: ABS, Firetrail, January 2024

Figure 2: Home and contents inflation measures (%)



Source: ABS, Firetrail, January 2024

2. Earnings forecasts do not need to be downgraded (yet).

The fall in 2-year Government bond yields over the past two months has removed upside risk from interest rates but is not implying any downside to consensus estimates at this stage. Note that every 50 basis points further fall in 2-year yields would reduce QBE's earnings by 6% and Suncorp's earnings by 4%. However, this should not be considered in isolation from the previous point on inflation.

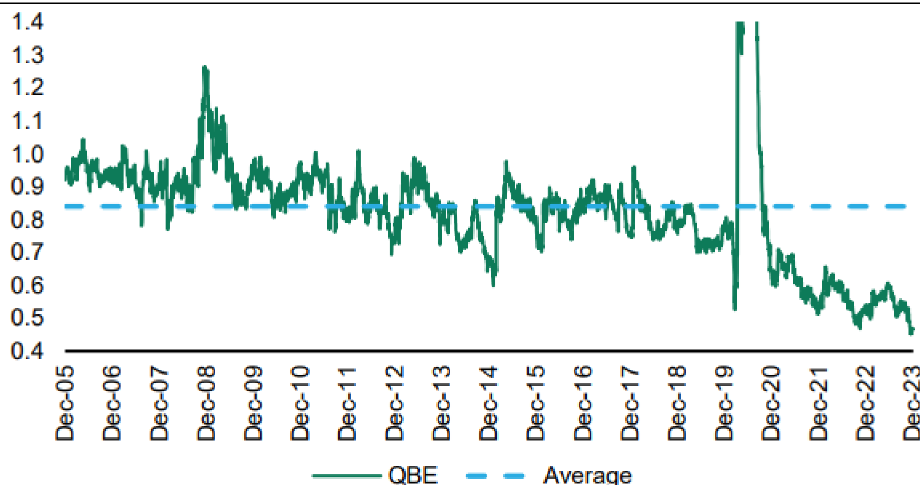
Recent weather events in NSW and QLD will put some pressure on reported margins in FY24, but this doesn't change our view that after a decade of under-provision the insurers have now established adequate allowances in guidance for events such as this.

3. Valuations are extremely cheap, even on discounted earnings.

On current 12-month forward consensus earnings, Suncorp is trading at a 17% discount to its 10-year average, and QBE is trading at a 40% discount.

In a scenario where cash rates and bond yields fall to 2%, QBE's earnings would be downgraded by 24% (conservatively assuming no offsetting benefit from lower inflation). On this basis, QBE would still be trading on only 11x earnings, and a 20% discount to its 10-year average PE-relative to the ASX Industrials.

Figure 3: QBE Insurance P/E ratio relative to ASX Industrials continues to trade extremely cheaply versus its history



Source: Firetrail, Factset, January 2024

Hard to find reasons to own Aussie banks

We believe the banking sector has downside earnings risk and is trading at an expensive valuation even if we were to believe the markets forecasts are accurate.

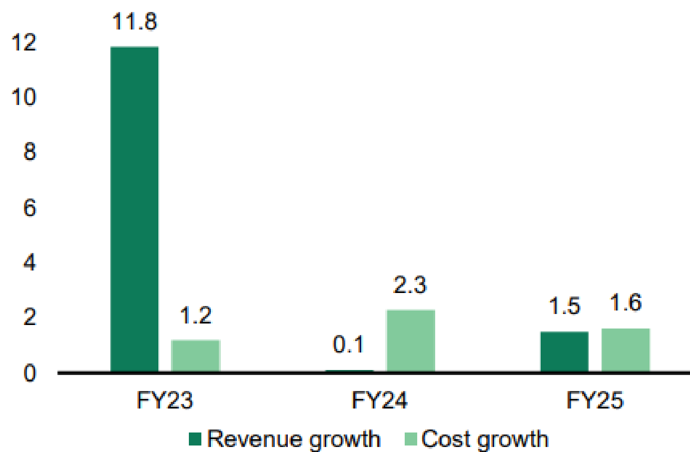
1. Profit 'jaws' are going in the wrong direction.

Bank net interest margins received a sugar hit through 2023 as mortgage rates followed the RBA Cash Rate higher and deposit rates lagged behind. However, margins are now coming down and look set to continue a downward trajectory over the next few years.

The NAB CEO supported this view at the FY23 result in November: "So, I think we're looking at it from a look-through perspective of thinking about 2021, 2022 and 2024. And sort of the blip in the middle of it all was 2023. It's nice to have had it, but it disappeared pretty quickly".

At the same time cost inflation appears embedded, with Enterprise Bargaining Agreements struck at 4-5% p.a. for the next few years. In that light, the below expectations for consensus revenue growth and cost growth appear too optimistic to us. We believe pre-provision profits will contract in FY24 and FY25.

Figure 4: Major bank consensus cost inflation and revenue forecasts for FY24-25 appear too generous in our view (%)



Source: Firetrail, Visible Alpha, January 2024

2. Not even a moderate cycle is built into bad debt forecasts anymore…

As expectations for a soft landing have increased, the market has been steadily ratcheting down its forecasts for major bank bad debts. Current forecasts for 2024-26 are for an average bad debt charge equal to 42 basis points of non-housing loans (stated this way to remove the mix impacts of higher mortgage growth).

2024-26 forecasts are on par with bad debts reported during the relatively prosperous periods of 1998-2000, 2005-07 and 2014-19. However, we believe a moderate slowdown synonymous with what transpired in 2000-01 is more likely over the next few years. During 2000-01, unemployment rose by 1.2%, GDP slowed to low single-digits, and the RBA cut rates from 6.25% to 4.25%. Bad debts reached ~65 basis points of non-housing loans in 2001/02, 55% above consensus forecasts for FY24-26.

This is an edited extract from Firetrail's Australian High Conviction Fund December 2023 monthly report.

Scott Olsson is Portfolio Manager for the fund. Firetrail Investments is affiliated with Pinnacle Investment Management, a sponsor of Firstlinks. This article is general information and does not consider the circumstances of any investor.

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Aged care star ratings are a 'fail'

Rachel Lane

In December 2022 the Federal Government introduced star ratings for aged care homes with the aim of providing simple, reliable information about the quality of care. The introduction of the star rating system was a recommendation of the Royal Commission into Aged Care Quality and Safety which said that the system was needed to provide senior Australian's and their families the ability to easily assess and compare aged care services based on measurable information.

A recent report by Dr Rodney Jilek titled "The Failure of the Aged Care Star Ratings" indicates that instead of providing the transparency older people need to compare and choose an aged care home, the star ratings may actually lead them to choose a home that is delivering poor care.

How the Star Ratings are determined

The star-rating system draws on data from the National Aged Care Mandatory Quality Indicator Program, consumer experience reports and provider compliance with and performance against the Aged Care Quality Standards as assessed by the Aged Care Quality and Safety Commission.

The star ratings are based on 4 domains.

- **Quality** – has the lowest weighting in the overall stars making up 15% of the rating. The quality measure uses data on five care quality indicators that operators provide to the government on a quarterly basis under the National Aged Care Quality Indicator Program.
- **Staffing** – has a weighting of 22% towards the total star rating. It uses data reported by the provider on the average number of care minutes each resident receives per day and how many of those minutes are with a registered nurse.
- **Compliance** – makes up 30% of the overall rating and is based on audits and non-compliance decisions made by the Aged Care Quality and Safety Commission.
- **Resident Experience** – has the greatest weighting contributing 33% to the overall rating. To measure resident experience the government will contract a third party to interview at least 10% of residents face-to-face about their experience at their aged care home. The interviews will be conducted annually.

Overall Star Rating

★★★★★ Excellent
★★★★☆ Good
★★★☆☆ Acceptable
★★☆☆☆ Improvement needed
★☆☆☆☆ Significant improvement needed

Source: Department of Health and Aged Care

The failure of the ratings

The report, by Dr Jilek, compared the 501 aged care homes on the Government's non-compliance register over 12 months from November 2022 with the star ratings those homes had received. "We targeted the homes on the non-compliance register mainly because they are supposed to be the worst in the country – they're all non-

compliant – so you would reasonably expect that they would represent the lowest ratings. What we found was that the majority of homes (300) were awarded 3 stars, which under the guidelines means that the home is providing "an acceptable quality of care". 68 of the homes had a 5-star rating for compliance and 81 had 4-star compliance ratings, ratings that (according to the guidelines) are impossible to achieve for homes that have been deemed non-complaint.

The report gives an example of an aged care home that was assessed as non-compliant in 2020, and over the past 3 and a half years has had sanctions imposed and been required to engage external advisers. The home has remained non-compliant for three and a half years and yet has an overall rating of 3 stars, with 4 stars for compliance.

In another example, an aged care home that has 3 stars overall and 3 stars for compliance has a chequered history of compliance spanning 20 years. In 2020 the home failed 7 of the 8 standards, in 2022 the home again failed 7 out of 8 standards. Despite the history, and the fact that the home remained non-compliant, the Aged Care Quality and Safety re-accredited the home for a further 2 years.

The report concluded that the star rating system does not meet its stated objectives of improving transparency, ease of search, facility comparison or to monitor and improve the quality of aged care.

Dr Jilek describes the resident experience measure as "completely useless", and says that "only 10% of residents are surveyed and the care provider can control the outcome by cherry picking the residents". He says that it is hard to have certainty around the staffing and quality measures because they are based on unvetted provider supplied data, with no validation or check measure to ensure that it is correct. The only measure being independently reviewed is the compliance measure, which is the role of the Aged Care Quality and Safety Commission, and they are giving homes 5 stars for compliance when they have determined that they are non-compliant.

The best research you can do

Undertaking research, such as that carried out by Dr Jilek, outside of the star ratings can be very difficult. While the list of aged care homes on the non-compliance register has a search function, it uses the name that the Aged Care Quality and Safety Commission has for the home (which is often different to the name you know the home by), the variation can be small or it can be significant, but any variation to the record will result in no listing appearing.

If you are investigating an aged care home for yourself or a loved one the best way to do your research is to have a respite stay. Respite is designed to give carers a much-needed break but it is also a great way to "try before you buy". Respite enables you to stay in an aged care home for up to a total of 63 days (9 weeks) per year. That time could be spent in one home or spread across a number of homes, which can be useful if you are unsure which home you are interested in.

A short stay of a few weeks is normally enough time for you to work out whether you like the activities, the other residents, the food and most importantly the care. Respite is also very affordable as there are no accommodation payments and no means tested fees. You simply pay the basic daily fee, set at 85% of the Age Pension, currently $61 per day plus any extra or additional service fees for things like hairdressing, wine and entertainment.

Respite is government funded so in order to get access you will need to have your care needs assessed by the Aged Care Assessment Team (normally just referred to as ACAT). The starting point is to contact My Aged Care either through their website or by telephone.

Having a simple, reliable measure of the quality of care an aged care home provides is crucial in working out whether or not you are going to get good value. Until you can have confidence in the star ratings, it's best to do your own research.

Rachel Lane is the Principal of Aged Care Gurus where she oversees a national network of advisers dedicated to providing quality advice on retirement living and aged care. She is also the co-author of a number of books with Noel Whittaker including best-seller 'Aged Care, Who Cares?' and 'Downsizing Made Simple'.

Does Bitcoin warrant a small allocation in portfolios?

Peter Lazaroff

On January 10, the Securities and Exchange Commission (SEC) approved the first U.S. exchange-traded funds (ETFs) that can directly invest in Bitcoin.

Until then, investors who wanted direct exposure to digital currencies had to trade on crypto exchanges and incur significant transaction fees. Or there were some ETFs that came out in 2021 that use futures contracts to gain exposure to Bitcoin price movements, but owning futures contracts rather than the underlying asset leads to differences in return due to the cost of carry.

These new ETFs that the SEC approved, however, are known as 'spot' price Bitcoin ETFs. Essentially, the term 'spot' indicates the fund's direct holding of Bitcoin rather than a derivative based on Bitcoin's price. And because the funds actually hold Bitcoin instead of derivatives, the ETF prices should, in theory, mirror the actual Bitcoin price movements in the cryptocurrency market.

So, for all of the investors that haven't wanted to deal with digital wallets, remember complex keys, or register on a cryptocurrency exchange—these ETFs offer an easy way to gain exposure through the same brokerages you would use for trading stocks, bonds, and other ETFs.

In many ways, this development reminds me of when gold ETFs launched in the early 2000s, which offered an accessible avenue to invest in gold via a common brokerage account rather than purchasing actual gold bars.

The only notable difference is in security. Most of the physical gold owned by gold ETFs is held in a giant vault underground in London. With Bitcoin, security is a valid concern as there is always a risk of cyber theft. ETF providers won't have an underground vault, but they do employ third-party custodians to securely store Bitcoin in offline 'cold storage' locations.

But I think it's a bit ironic that the SEC's social media accounts were hacked, and a false notice of approval was sent out just a day before the ETF filings were actually approved. There is no doubt that this space is rife with risk.

Should you invest in spot Bitcoin ETFs?

Investing in something simply because it has been going up recently or you fear of missing out on future returns isn't a good reason to invest in spot Bitcoin ETFs. You really should only be investing in Bitcoin ETFs if you see value in doing so.

I've consistently been publishing content on cryptocurrency since 2017, and what has changed the most over time has been the complete demise of the case for Bitcoin as a currency capable of replacing government money—nearly all of Bitcoin's proponents agree that it is extremely unlikely, if not impossible.

People often laugh about the guy who bought two pizzas for 10,000 Bitcoin in 2010 because it would now be worth over half a billion dollars. Using any medium of exchange shouldn't cause potential for regret. My family gets pizza delivered once a week using US dollars and never once have I needed to worry about whether using my currency would be a mistake.

Even though proponents have seemingly acknowledged Bitcoin's shortcomings as a medium of exchange, I still hear people promote its status as a store of value is shaky at best—but that isn't something that should cause price to soar.

Bitcoin more closely aligns with collectibles

Regardless, because Bitcoin prices are not based on economic fundamentals, but rather depend on speculation about the adoption and use of cryptocurrencies, the uncertainty and resulting high volatility completely undermine the idea of it being a store of value.

The idea of buying cryptocurrency to 'buy blockchain' doesn't really make sense either.

Owning Bitcoin doesn't give someone any ownership in the underlying blockchain. Even if it did, the blockchain technology that underlies Bitcoin does not power the same blockchains used by the wide range of governments, corporations, and financial institutions utilizing blockchain technology.

The idea that blockchain might revolutionize the world is valid, but 'buying blockchain' would be like somehow buying 'http' which is the foundation of any data exchange on the Web – it might have been part of the function, but the real commodity was the specific URLs.

Bitcoin isn't a commodity either, but the idea that it's a form of 'digital gold', which may be true from strictly a sentiment perspective but couldn't be further from reality otherwise.

If anything, Bitcoin is more closely aligned with collectibles like art, baseball cards, and Beanie Babies that have aesthetic or emotional value, but that derive their pricing from scarcity in supply and level of demand.

Implementing a bad idea vs missing out on a good one

It would be easy to categorize me as anti- Bitcoin or anti-cryptocurrency, but that isn't necessarily true. I'm simply more concerned about implementing a bad idea than missing out on a good one.

Building a diversified portfolio requires you to combine exposures with various risk and return characteristics that behave differently over time. By combining exposures that zig with others that zag, the volatility of a portfolio's overall returns is reduced. That, in turn, allows the portfolio's returns to compound at higher rates.

(If you compare two portfolios with the same average return and different levels of volatility, the lower volatility portfolio will have higher compounded returns and a greater ending value than the portfolio with higher volatility.)

Of course, every new exposure added in the name of diversification comes with a diminishing marginal benefit, so you must carefully weigh the expected net benefits versus the degree of uncertainty.

Bitcoin certainly behaves differently than traditional asset classes such as stocks and bonds, but it doesn't offer any expected premium for bearing the risk of Bitcoin's price movements. That increases the already high uncertainty around the net benefit from including such an exposure to a portfolio.

Bitcoin prices depend mostly on speculation about its adoption and use. While the increase in institutional adoption has helped drive price higher, it still lacks an enduring economic rationale that would allow anyone to expect Bitcoin to general positive real returns over time.

Perhaps that will change over time.

Because I'm generally more concerned with implementing a bad idea than missing out on a good one (a preference for minimizing Type I error for all you quant geeks), I'm not a believer in Bitcoin as a strategic diversifier.

Two reasonable ways to think about Bitcoin investing

If you're thinking about investing in Bitcoin, I think there are two reasonable ways to go about it:

The first is treating it like an investment in an individual stock.

That actually seems to be the most logical approach. While the risks of owning individual stocks are a bit different, there are some decent parallels between the betting nature of owning an individual coin like Bitcoin or Ethereum or whatever your coin of choice may be.

Carving out some part of your portfolio to actively trade can actually be a good thing if it helps you stay the course with your long-term allocation. If you hit it big with your active portfolio, great. If you don't, at least you've limited your exposure to speculative assets.

The second way to incorporate Bitcoin into your portfolio is as a strategic part of your long-term allocation.

With more products coming to market, I suspect more and more people will be interested in this route.

If that's the case, here's how I think about allocating to a new exposure: I start by considering the relative market weight of that exposure compared to the relative weights of your other portfolio assets.

For example, the global stock and bond markets have market capitalizations of roughly US$75 trillion and US$135 trillion, respectively. Bitcoin's market value is just over US$910 million as of this recording, but let's round up to US$1 trillion. So an asset allocator's starting point might be 0.50% of a portfolio to Bitcoin (US$1 trillion divided by US$200 trillion).

If you go either of these routes with Bitcoin or other cryptocurrency exposure, I strongly suggest you follow a set strategy and try to remove emotional decision-making as much as possible.

Peter Lazaroff, CFA, CFP® is Plancorp's Chief Investment Officer, a financial advisor, speaker, and author of the book Making Money Simple. This article is an edited transcript from a recent episode of Peter's podcast, The Long Term Investor.

Charter Hall Group: quality company at a steep discount

Jack McNally

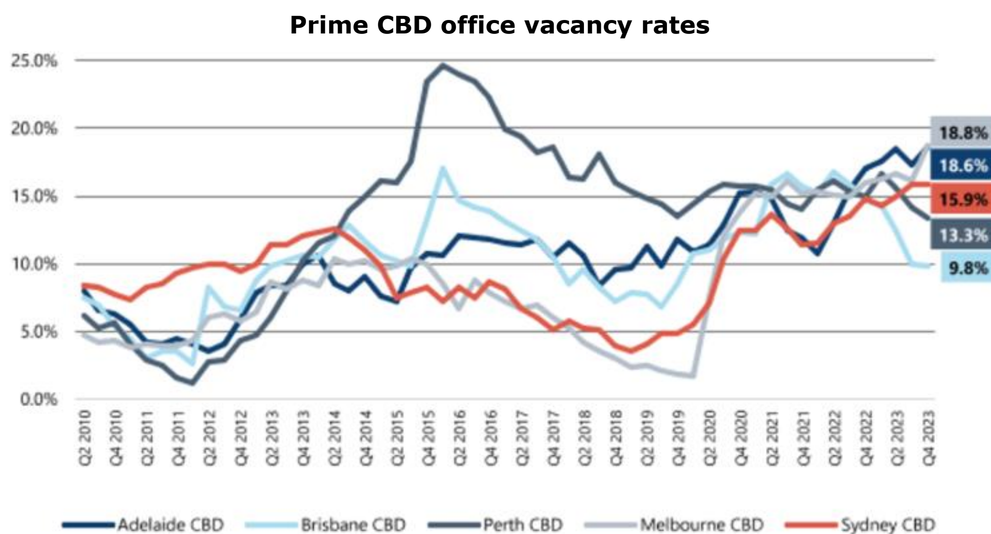
Business quality is a key factor in our investment process, and we typically define a high-quality business as one that can earn a decent return on its capital. The Real Estate Investment Trust (REIT) sector is not typically thought of as a high total return sector due to the low-yielding nature of real estate and high capital intensity to just 'stay in business'. That said, it may come as a surprise that Charter Hall Group (ASX:CHC) has delivered a total return of ~11.5% p.a. since its IPO in 2006. This performance has been driven largely by CHC's transition from a traditional REIT to a fund manager, which generates fees on client capital with minimal amounts of incremental investment required.

Now, I know you are probably thinking, "Why would I want to invest in an office fund manager, particularly in the current interest rate environment?" We believe these risks are more than captured in CHC's current price and have provided the opportunity to invest in a high-quality business at an attractive valuation.

But isn't office property dead?

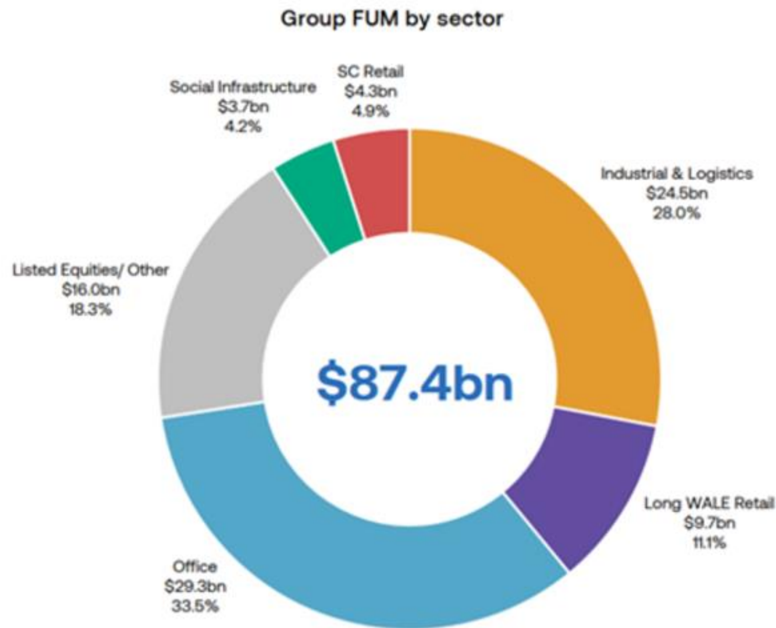
We don't disagree that the 'Work From Home' trend has created meaningful challenges for the office sector. Corporates have quite reasonably concluded they can achieve substantial rent savings while providing their workforce with increased flexibility. This has resulted in an increase in market vacancy and placed pressure on rents.

Prime CBD office vacancy rates



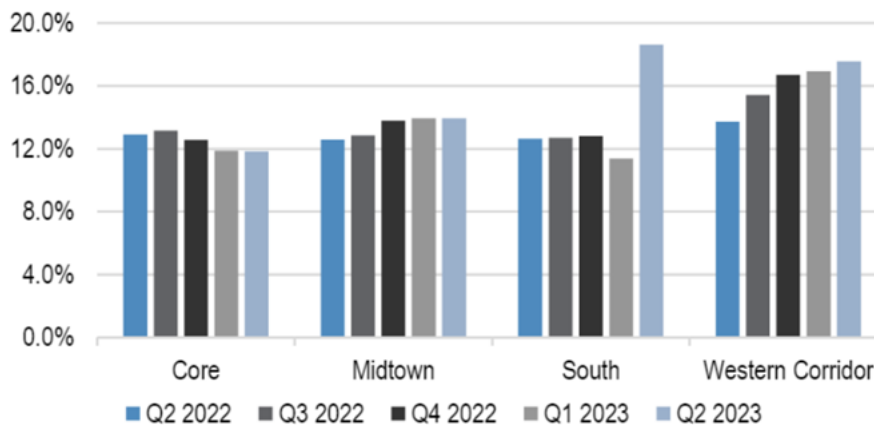
Source: Jefferies, JLL

This has understandably weighed on Charter Hall, with the share price down 48% since its peak of $21.83 in 2021. While Charter Hall will undoubtedly be affected by weakness in Office, we believe the criticism is not entirely fair given roughly two-thirds of its Funds Under Management (FUM) is in 'non-office' sectors, including Industrial and Logistics (28%), Equities (18%), Retail (16%) and Social Infrastructure (4%).



Source: Charter Hall

Further, the real estate cliché 'location, location, location' remains as relevant as ever. The fundamentals for well-located, new and environmentally friendly buildings are markedly different from those that do not have these characteristics. The figure below highlights the divergent vacancy trends seen between core and non-core regions of Sydney CBD. Equally, the vacancy rate for buildings in Sydney that are less than 10 years old is ~6% versus ~13% for those over 10 years old.



Source: JLL and Charter Hall Research

CHC's Office Portfolio skews to newer, better-located buildings, which has led to superior outcomes including 96% occupancy (vs 85% national average), 89% leasing retention rate and a high-quality tenant base like the Australian Government, multinationals and listed companies (which account for 56% of the Group's property platform income).

What about high interest rates?

It wouldn't be an investor communication without a quote from Warren Buffett, who said, "Interest rates are to the prices of assets like gravity is to the function of earth". As such, it's no surprise that the 10 Year Australian Government Bond Yield rising from <1% during the pandemic to almost 5% weighed on an asset manager like CHC. Most obviously, it has reduced the value of the assets that it manages and charges fees on.

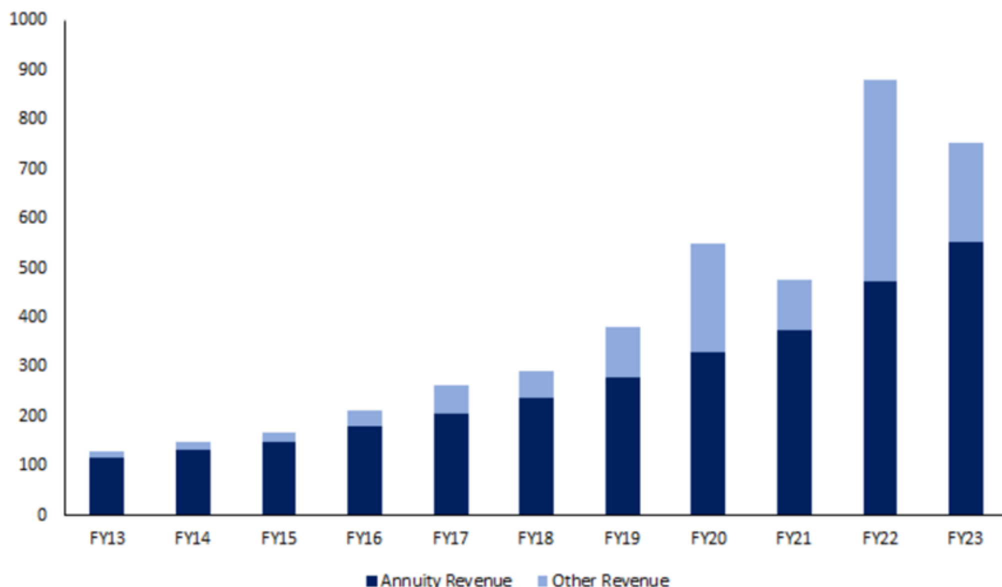
Source: Federal Reserve Bank of St Louis

Second, the rapid increase in interest rates has frozen transaction activity in the sector with investors unwilling to make long-term, illiquid investments for fear the price of the asset could fall in the near term. This is not ideal for Charter Hall where transaction activity allows it to acquire new assets, increase its FUM and thereby grow earnings.

While we don't claim to be economic forecasters, we'd argue that with interest rates at 10-year highs and inflation measures falling, it seems more likely than not that interest rates have peaked. We believe this peaking of interest rates is likely to see transaction activity begin to return and allow CHC to mitigate devaluations in its FUM. From FY19 – FY23 CHC added $5.7 billion per year to FUM from acquisitions and $2.0 billion p.a. from developments. Therefore, a return to average transaction and development activity would sufficiently offset a 10% decline in current Property FUM of $71 billion due to devaluations.

Underappreciated business quality

CHC trades at ~15x FY24 EPS guidance, which is a large discount to the ASX 200 of ~22x (excluding financials and resources) despite a track record of growing EPS at 15.1% p.a. over the last 10 years.



Source: Charter Hall

We believe CHC is a higher-quality business than it is given credit for, with several factors often overlooked:

- ~73% of its revenues are highly recurring, creating a stable, lower risk earnings stream for shareholders, which therefore should warrant a higher multiple.
- CHC's FUM are relatively 'sticky', meaning they cannot be easily or quickly redeemed. This is somewhat a by-product of redemption terms being structured to align with the fact that the underlying investments are large and illiquid:
- ~72% of FUM is in 'Wholesale' (unlisted) strategies where institutional investors typically have redemption windows every 5 – 7 years, meaning they cannot pull their money out quickly.
- ~15% of FUM is in 'Listed' vehicles, which more or less cannot be redeemed.
- ~12% of FUM is in 'Direct' (unlisted) strategies for HNW individuals, which can typically be redeemed only every 5 years.
- Many of CHC's 'wholesale' investors have a lower cost of capital (return requirement), which means CHC can pay more for assets, providing it with an advantage in an auction for an asset.
- There are few other Fund Managers in Australia with the ability to purchase large assets worth more than >$1 billion, which further reduces competition in auctions for CHC.
- Funds Management EBITDA Margins have grown over the last ten years to 73%, highlighting the business's scalability. Even after removing the more volatile transaction and performance fees, the EBITDA margin is 62%, which reduces operating leverage and creates a stable earnings stream.
- As Charter Hall's funds management business has delivered strong performance, and its relationship with equity partners improved, CHC has not needed to 'seed' its investment vehicles with the same proportion of capital. This reduces its overall capital requirements of the business, allowing for both a higher return on capital and greater returns to shareholders.
- While there is implied leverage related to Charter Hall's investments in its own funds, at the group level, CHC has a very clean balance sheet with virtually no net debt, which provides it with optionality, particularly in a more difficult real estate market.

Attractive valuation

CHC has rising margins, decreasing capital requirements, proven earnings growth and business quality. Further, we view the company's FY24 guidance of 75 cents per share as 'trough' earnings given it implies virtually no performance or transaction fees. If we normalise FY24 performance and transaction fees to a level that is in line with historical averages, CHC would be trading at ~10x FY24 EPS. We believe that if inflation continues to fall, interest rates stabilise and there is discussion of rate cuts – as we have seen in recent months – CHC's multiple should re-rate to account for the cyclically low earnings and depressed multiple.

Jack McNally is an Investment Analyst at Magellan-owned, Airlie Funds Management. Magellan Asset Management is a sponsor of Firstlinks. This article has been prepared for general information purposes only and must not be construed as investment advice or as an investment recommendation. This material does not consider your investment objectives, financial situation or particular needs.

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Should you be worried about high-flying markets?

Jonathan Daffron

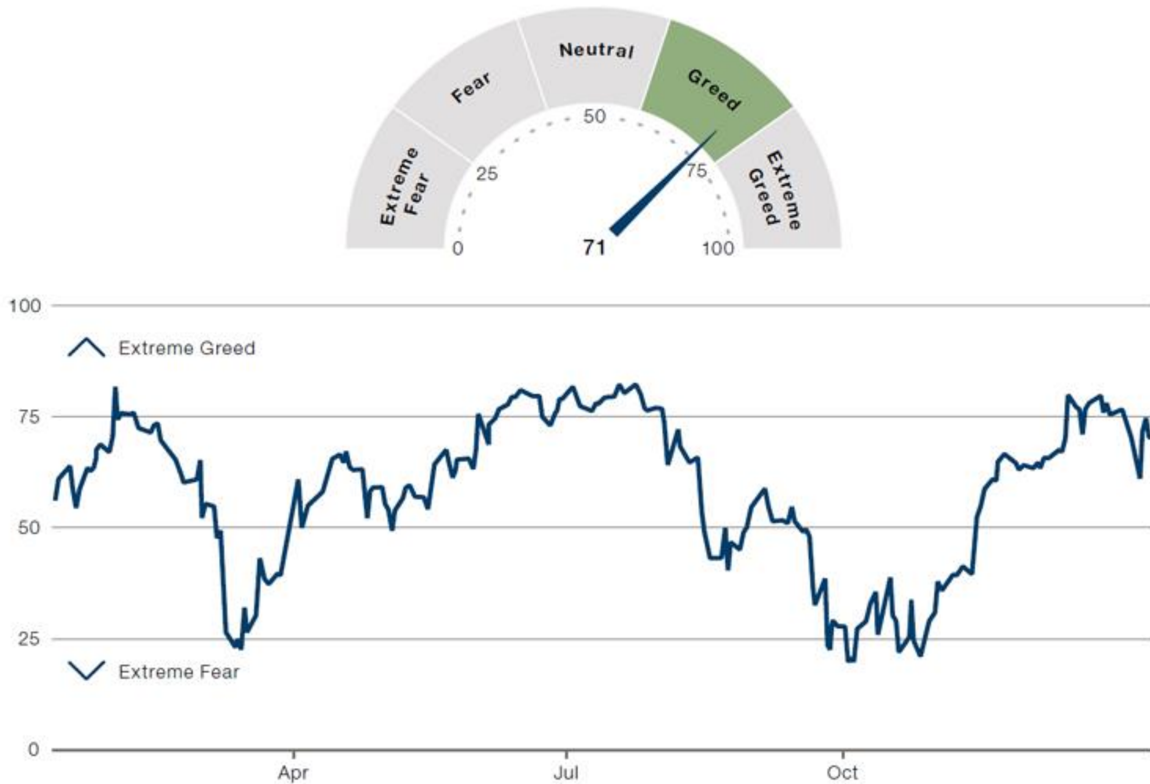
"Be fearful when others are greedy and greedy when others are fearful."

A glance at the Fear & Greed Index, used to gauge the current mood of the market, brings this well-known quote from Warren Buffett to mind. The Index has moved from 'fear' just over a year ago, to 'greed' in November 2023, and is now close to 'extreme greed' mode.[1]

Digging into the index's underlying indicators, it's worth noting that four of the seven inputs are pointing to 'extreme greed' (including market momentum, stock price strength, stock price breadth and junk bond demand) while the put/call ratio points to 'greed'. The only inputs that are keeping the index from what could be all-time extreme greed level are market volatility, which is at 'neutral' but trending towards greed with the low level of the VIX, and the demand for safe haven assets which is currently registering 'neutral'. The latter

should be taken with a pinch of salt with US Treasury bond yields as elevated as they are. Risk-free yield has a definite allure at present – even for investors who are not looking for a safe haven.

Figure 1. The market is close to 'extreme greed' mode



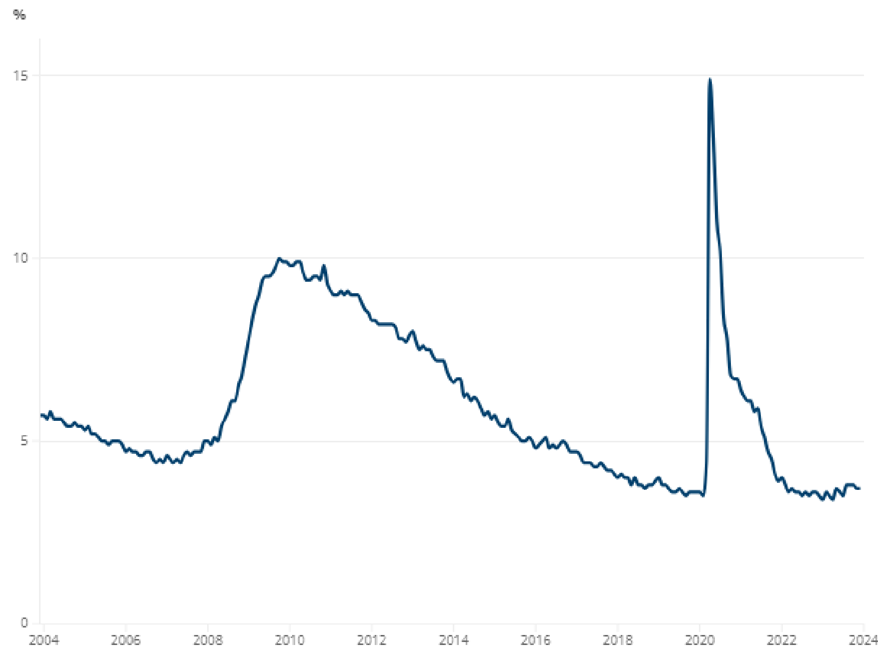
Source: CNN Business, as at 12 January 2024.

Before we delve into why this greed measure might be more of a warning than a sign of good things to come, let's first consider why the market is seemingly so exuberant: for that, we need to look to the Federal Reserve (Fed). The Fed has been fighting pandemic-fuelled inflation now for the better part of two years, and if the graph below tells us anything, the Fed, after initially missing the damage that was done to price stability, is doing an admirable job. It has managed to bring down inflation to low single digits from the June 2022 peak and has done so without hurting its other mandate of unemployment (figure 3) which has remained below 4% since February 2022. The market loves the fact that to date the Fed has seemingly been able to thread the needle of a soft landing – November 2023 was the largest cross-asset rally since before the Global Financial Crisis – but how soon the Fed can start easing monetary policy is a matter of great debate.

Figure 2. US Consumer Price Index - Inflation now at low single digits from its June 2022 peak

Source: US Bureau of Labor Statistics. Available here: www.bls.gov/charts/consumer-price-index/consumer-price-index-bycategory-line-chart.htm

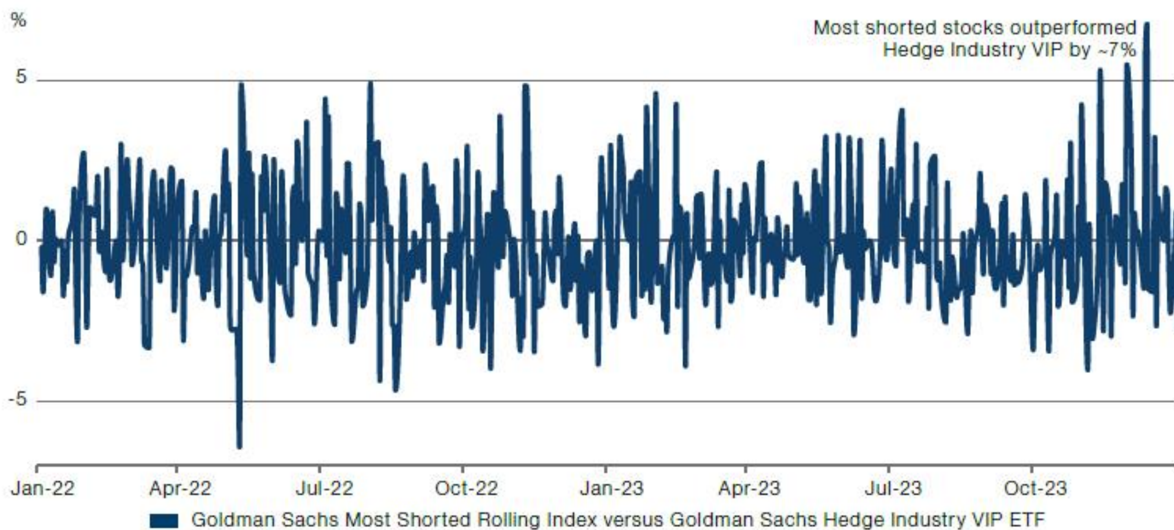
Figure 3. US unemployment remains steady since February 2022



Source: US Bureau of Labor Statistics. Available here: www.bls.gov/charts/employment-situation/civilian-unemploymentrate.htm

From what we've seen in recent weeks, the market's shift to risk-on has been especially painful for short sellers being squeezed as the market melts up. In December 2023, the most shorted stocks (as measured by the Goldman Sachs Most Shorted Rolling Index) rallied 21%. Compare that to the most held long positions by hedge funds (proxied by the Goldman Sachs Hedge Industry VIP ETF) which is only up 3%. This feels like a sign of capitulation as market participants give up the ghost of a hard landing. But has that call been made too soon? Rates markets don't think so.

Figure 4. The junk rally



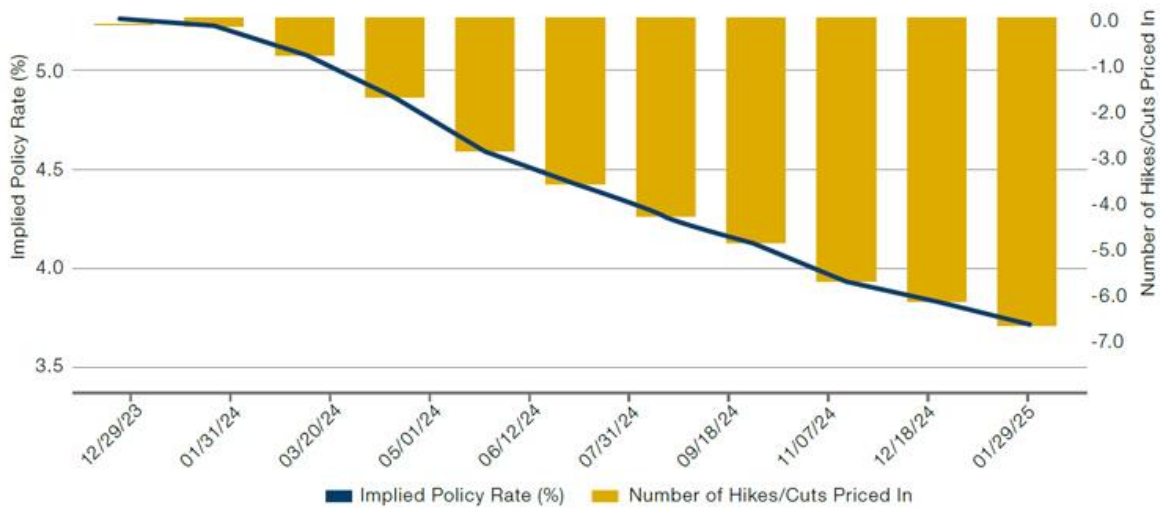
Source: Bloomberg, as at 31 December 2023.

We can gauge the market's expectation on the path of the Fed funds rate by implying probabilities through futures pricing. Through this lens, we see that the market is implying almost a full 25bps cut to rates (actually, 22bps) with an estimated 75% probability of this happening at the March 2024 meeting, and a further 125bps(!) of cuts spread throughout the rest of 2024. That means that there are six 25bps cuts priced in for 2024 during eight meetings (January, March, May, June, July, September, November and December).

It seems unlikely that the Fed would take action during September and November unless absolutely necessary (i.e. recession), namely because it is unlikely to want to be seen as political and as having an impact on the US

presidential election. This would mean that the Fed would need to make the majority of its cuts at the first six meetings. January seems unlikely for a cut – the Fed is still data-dependent and waiting for the effects of higher rates to slowly cool the economy. So that leaves only the March, May, June and July meetings to cut. The implied rate cuts through to the July meeting is nearly a full 100bps. That would mean 25bps cuts at each of those four meetings. This seems unlikely unless one of two things take place: 1) the US economy takes a sharp nosedive and/or unemployment rises dramatically; or 2) there is a large, idiosyncratic risk-off event.

Figure 5. Implied US interest rate and number of Fed cuts during 2024



Source: Bloomberg, as at 29 December 2023.

The US economy proved to be quite resilient in 2023. Annual GDP growth for 3Q2023 rose at 4.9%, up from 2.1% in 2Q2023.[2] So the likelihood of a sudden US economy nosedive seems low. As referenced earlier, unemployment has been steadily below 4% since the beginning of 2022, and the stimulus effect of the market rally has allowed for tighter financial conditions to continue, so the odds of a sudden hard landing feels remote.

That brings us to the second possibility: a large idiosyncratic risk-off event. The scary thing about such events is that we rarely see them coming. Unfortunately, however, there are enough hot spots geopolitically to make the risk-aware hairs on the backs of our necks stand up.

The Russia-Ukraine conflict comes to mind first. When it began in February 2022, it exacerbated the existing inflationary forces in the market. Geopolitical turmoil in the Middle East can have an outsized impact on the global economy, and yet the market seems to be underpricing the impact of the Israel-Hamas war and conflicts in the Red Sea that are arising. In response to recent attacks on commercial ships in the Red Sea by Houthi rebels, we saw the US and UK carry out targeted strikes in Yemen on 11 January, raising fears about further escalation of conflict in the region. An estimated 30% of global trade traverses the Red Sea each day and is a crucial route for the world's oil trade. The Red Sea has become even more important for Russian oil shipped to Asia as European countries have shunned Russian oil imports following the invasion of Ukraine. A potential blockage of the Red Sea, and more specifically the Suez Canal, would interrupt not just oil shipments, but also cause supply chain issues for key consumer goods like Chinese car parts and Indian cotton. These supply chain disruptions, even if only temporary, would likely cause an uptick in inflation giving support to the Fed to keep rates higher for longer, or even hike the target rate further.

Idiosyncratic risk-off events have a way of spreading into global markets, and in this case, there's the potential for them to undo some of the work that the Fed (and other central banks) have done to fight inflation. If we were to see another wave of rising inflation, then it's safe to say that we won't see the Fed Funds rate 150bps lower in 2024.

Conclusion

This all puts the Fed on a knife's edge. The market is giving it the proverbial thumbs-up on a job well done, and yet there feels like there is nearly balanced risk between the Fed being able to declare mission accomplished and start easing again, and the risk that inflation isn't dead yet and could be exacerbated by forces outside of the Fed's control which would mean it has to disappoint the market and return to tightening.

All in all, the potential upsides and downsides of the current market environment don’t provoke tremendous optimism. Given how 'greedy' the market is currently looking, it may well be that the risks that loom in 2024 are underpriced.

1. As at 12 January, 2024. For more on the inputs to this metric, see this page: Fear and Greed Index - Investor Sentiment | CNN.
2. Source: www.bea.gov/data/gdp/gross-domestic-product

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Einstein's relativity theory and finance

Tony Dillon

The life and works of Albert Einstein have long fascinated me and reading a book on his famous theories over the summer break, brought out my inner physics geek. As I delved deeper into his Theory of Relativity, I wondered, could any metaphorical parallels be drawn with money and finance?

The theory, simply put

Einstein concluded that because the speed of light is absolute no matter one’s frame of reference, then time and space are relative concepts.

For example, if I am at rest and a friend flies past me in a rocket at 90% of the speed of light, both of us will measure the speed of an oncoming photon of light to be the same. That speed being a universal constant and upper limit on the speed of any physical particle in the universe at 3.0 x 10^8m/s. How can that be?

When Einstein realised that the speed of light was absolute, it set him on a path towards his theory of relativity. Which basically infers that the invariance of the speed of light is such that time and space must compensate. That they are malleable and can vary depending on an observer’s relative motion. That time and space are intertwined.

How does Einstein’s theory align with money and finance?

Just like time and space, money is relative. Both in terms of perceived value compared to others, and in individual terms at various stages in life. A million dollars may be of huge value to most of us, but to an elite cohort, it may just be a rounding error in their high-life transactions. And money that may be frittered away with gay abandon in one’s youth, suddenly becomes far more protected in retirement.

The constancy of the speed of light to all observers in relative motion might be comparable to the importance of financial concepts that are also constant over time. Such as supply and demand, and risk and reward. Just as space and time are inextricably linked in Einstein’s world, so too are risk and reward in the world of finance, and supply and demand in economics.

Consequences of relativity theory are time dilation and length contraction. An object moving at a constant velocity experiences time more slowly than if it had been at rest. And as time and space are interdependent, then a reduction in time must be accompanied by a reduction in space, known as length contraction. This also ensures the speed of light remains constant, no matter the frame of reference.

Note that only at speeds of a significant fraction of the speed of light, does time dilation and length contraction become material. This is shown here diagrammatically for the brave.

Just as speed squeezes time, so too does the speed with which the price of goods and services rising in the economy, squeezes money. This has never been more evident than in recent times, with inflation reducing the purchasing power of money within a short space of time. The value of money today can be very different to that in the past and in the future.

And the length of time required to achieve financial goals, contracts with compounding interest. Einstein once said, "compound interest is the eighth wonder of the world. He who understands it, earns it. He who doesn't, pays it". Invested wisely, time grows money. Time can lengthen money.

Relativity equations map space and time coordinates in one frame of reference, to a different set of coordinates in another relatively moving reference frame. Similarly, financial modelling and economic forecasting may map to different outcomes on for example, movements in regulatory or geopolitical settings, and market shocks such as pandemics and wars, which may severely impact supply chains and monetary settings.

Finally, depending on one's motion according to Einstein, observations can be relative. Perspectives on certain asset types can similarly be relative and influenced by factors such as risk appetite, investment horizon, and market conditions.

There you have it. Physics and finance may not form quite the continuum that space and time does, but sometimes trying to align underlying principles on unrelated topics can inspire new thinking, reinforce concepts, and offer insights into sometimes complex issues.

Tony Dillon is a freelance writer and former actuary. This article is general information and does not consider the circumstances of any investor.

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