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Contents

The best strategy to build income for life *Peter Thornhill*

CPI lowballs the true cost of living *Peter Martin*

The latest trends in SMSFs *Derek Gascoigne*

4 ASX small caps poised for a big year *Romano Sala Tenna*

Passive investors exposed to bubbliest market segment *Eric Marais*

Why is land lease housing booming? *Cameron Murray*

Challenges for the Magnificent Seven stocks *Raheel Siddiqui*

Editorial

Lately, I've been reading a book by Robert Fulghum called, *All I really need to know I learned in kindergarten*. The book became a bestseller in the 1980s for its quirky short stories on the meaning of life.

In one story that became a cult hit, Fulghum realises that he already knows what's necessary to live a meaningful life – and he's known for long time. He learned it in kindergarten.

These are the things he learned:

Share everything.
Play fair.
Don't hit people.
Put things back where you found them.
Clean up your own mess.
Don't take things that aren't yours.
Say you're sorry when you hurt somebody.
Wash your hands before you eat.
Flush.
Live a balanced life – learn some and think some and draw and paint and sing and dance and play and work every day some.
Take a nap every afternoon.
When you go out into the world, watch out for traffic, hold hands, and stick together.
Be aware of wonder. Remember the little seed in the Styrofoam cup: the roots go down and the plant goes up and nobody really knows how or why, but we are all like that.
Goldfish and hamsters and white mice and even the little seed in the Styrofoam cup – they all die. So do we.
And then remember the Dick-and-Jane books and the first word you learned – the biggest word of all – LOOK.

Yes, the lessons are corny. Yet they include essentials like the Golden Rule, love, politics, the environment, and basic sanitation. As Fulghum notes:

"Take any one of those items and extrapolate it into sophisticated adult terms and apply it to your family life or your work or your government or your world and it holds true and clear and firm. Think what a better world it would be if we all – the whole world – had cookies and milk about three o'clock every afternoon and then lay down with a our blankies for a nap. Or if all the governments had as a basic policy to always put things back where they found them and to clean up their own mess.

And it is still true, no matter how old you are – when you go out into the world, it is best to hold hands and stick together."

The purpose of schools

Fulghum's stories got me thinking about what our kindergartens and schools teach and don't teach. Teaching values is central to what they do. As is teaching reading, writing, and understanding numbers. These skills provide the building blocks for understanding the world, and eventually helping kids find work that provides an income for them.

Practical skills aren't on school curriculums as much nowadays. I'm thinking of cooking, cleaning, maintenance (of gardens, for instance), making and fixing things, as well as money and investing. All these skills are essential for kids as they turn into teenagers and then young adults. The question is: why aren't these skills taught in schools?

I have friends and family who are teachers, and I can already see them metaphorically grabbing hold of me and giving me an earful. They would probably say a few things (a few too many, perhaps):

1. They can't teach everything.
2. They already have enough on their plate.
3. Some practical subjects are taught in schools, such as technology, economics, and science.
4. It's the parents' job to teach practical skills to their children.

The last point is important. Parents have a big say on their child's development. On their values, and their education. Scientific studies suggest that children with parents who are more involved in their education get better results and better jobs. And parents can teach practical skills to their children too.

But what if parents aren't equipped to teach their kids about money and investing, for instance? What happens then?

In my case, I learned maths and accounting at school. The latter acquainted me with the language of business and investing but didn't provide me with tools to use in the real world.

My guess is that most kids are like me when they leave high school - they don't know enough about the basics of money and investing.

Changing the status quo

Obviously, changing school curriculums to include things like investing is a huge ask. Any effort would need significant funding and commitment. It would also need the support of governments, schools, and businesses.

What can be done?

In the case of money and investing, here is what I would love to be made compulsory in all schools across Australia:

- In year one, there's a program to learn about the basics of money and saving. CBA ran the Dollarmites program in schools for 90 years until 2022, when it was closed after complaints that it was using the program to promote the bank rather than for financial literacy. Why can't governments demand that all the major banks sponsor and co-run a similar program? Perhaps making it part of the obligations of their banking licenses?
- In year five, a similar program reiterating earlier lessons and updating them for 'tweens' who are developing their own spending and savings goals.
- In year seven, get experts in passive exchange traded funds and listed investment companies to talk about the basics of investing and investing in the whole stock market. And practical tools to implement this ie. getting parents to sign children up as minors on share trading accounts.
- In year eight, get leaders of large businesses to come in and talk about the nuts and bolts of how their companies make money. For instance, get the students into a local Bunnings store and get the store manager to talk through the nuts and bolts of the business. How it makes money, costs, labor issues, etc. Get the students to do assignments on the pluses and minuses of these businesses.
- In year nine, bring fund managers in to speak to their businesses and how they invest. Make it practical by perhaps visiting the sites of some of their investments and going to an investor presentation or AGM.
- In year ten, get superannuation funds experts in to go through the basics of the super system. The different funds, options, and costs. And go through practical examples on each.

Is a broad-ranging program like this unrealistic? Perhaps. It would require federal and state governments, major businesses, super funds, and investors to come together to make it work. It would need money and

leaders willing to give time to the effort. It would need checks and balances to make sure that businesses don't use it as a marketing opportunity.

But surely we can do better to help younger people navigate the world of money and finance?

James Gruber

In this week's edition...

It's great to have **Peter Thornhill** back. Peter is well-known to our readers as an independent author and speaker advocating a multi-decade investment strategy of holding industrial companies for income. Today, he updates us on the long-term returns from industrial shares versus the index. He also adds comparisons with listed property, resource stocks, and term deposits. Peter explains why his strategy has stood the test of time, and should continue to do well.

Consumer price index figures out this week show a welcome fall in the annual rate. Yet, does this index accurately reflect the actual cost of living? **Peter Martin** suggests that it clearly doesn't, and he has proof. He says the ABS publishes other estimates that provide a much clearer picture of living expenses, especially how they've risen of late.

Here's a fascinating datapoint for you: the average age of UniSuper members rolling out to an SMSF is 50, while the average age of members who roll money in from an SMSF is age 62. **UniSuper's Derek Gascoigne** explores this and other SMSF trends, as well as the pluses and minuses of administering your own super fund.

Are ASX small cap stocks set to play catchup and outperform their larger peers this year? Many people think so, though **Katana's Romano Sala Tenna** isn't sure. If it's right, he thinks there are four small caps worth considering for your portfolio.

One of the hottest plays in residential real estate investment is the land lease community. Currently, this model of ownership houses 130,000 Australians and there are many more projects in the pipeline. **Cameron Murray** does a deep dive into the business model and whether it works for both residents and landlords.

Thanks to the 'Magnificent Seven' tech stocks, global passive investors thrashed most active peers in 2023. But **Orbis' Eric Marais** says these investors shouldn't celebrate too soon because their portfolios are now concentrated in the most overvalued segment of the market, making them especially vulnerable if these stocks take a tumble. Meanwhile, **Raheel Siddiqui** of **Neuberger Berman** sees challenges ahead for the Magnificent Seven from stretched valuations, inherent cyclicality, and high correlations between the stocks.

In this week's whitepaper, **VanEck** provides its latest asset allocation outlook.

Finally, we'd like to give a shoutout to a new website on listed investment companies (LICs) created by Firstlinks' subscriber, **John Fox**. After retiring, John studied up on LICs, and recently open-sourced the findings. You can now find his latest research on the Firstlinks website. We've found it helpful and we hope you do too.

The best strategy to build income for life

Peter Thornhill

(Editor's introduction: Peter Thornhill is well-known to our readers as an author and speaker advocating a multi-decade investment strategy of holding industrial companies for income. His previous articles in Firstlinks are here. In this update, he again checks the long-term return from industrial shares, adding comparisons with listed property and term deposits. He argues that for investors with the right risk capacity and investment horizon, there's only one place to invest).

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Another year has passed and it's my favourite time. I get to update my presentation material highlighting, yet again, the inexorable creation of wealth by investing in productive enterprises.

Let's now look at the major indices, price only index first.

As always, digging stuff out of the ground clearly remains at the bottom of the wealth creation ladder. By adding the resources to the Industrials index we can drag it down to the All Ordinaries. Please note the proximity of the Resources Index to the All-Ords Index, both at around $1.4 million.

The difference between the Industrials and the other two indices is due to TIM! That is, the Technological, Intellectual, and Manufacturing inputs that convert resources into almost everything.

There is a critically important element missing from this chart and you will not be surprised if I said it was the dividend stream.

The second chart shows the impact of reinvested dividends. Note that the All-Ords index now jumps up from the Resources Index reflecting the ever-poor cash flow from many resource companies, and the Industrials Index soars.

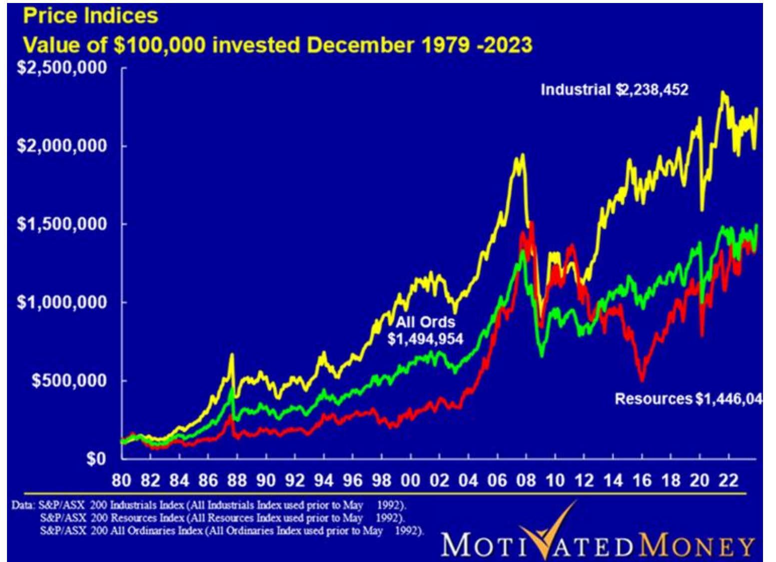
The third chart now compares the annual cash flow from deposits to the dividends from the industrials. The huge gap continues to widen despite the GFC and the Covid intervention. It is important to remember that a large proportion of the dividend reductions were simply due to companies reducing or cancelling dividends during the uncertain times where government intervention cramped economies. We are now seeing the normalisation of dividends which was to be expected.

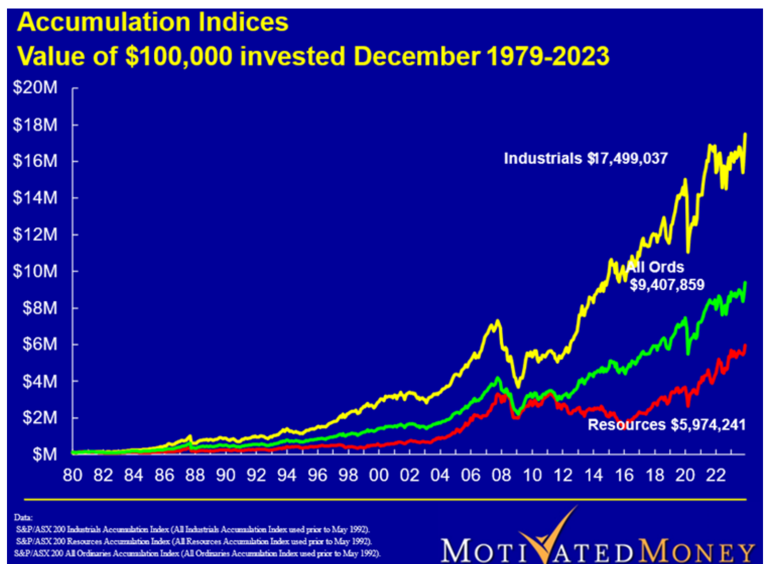
The opportunity cost of investing in alternatives

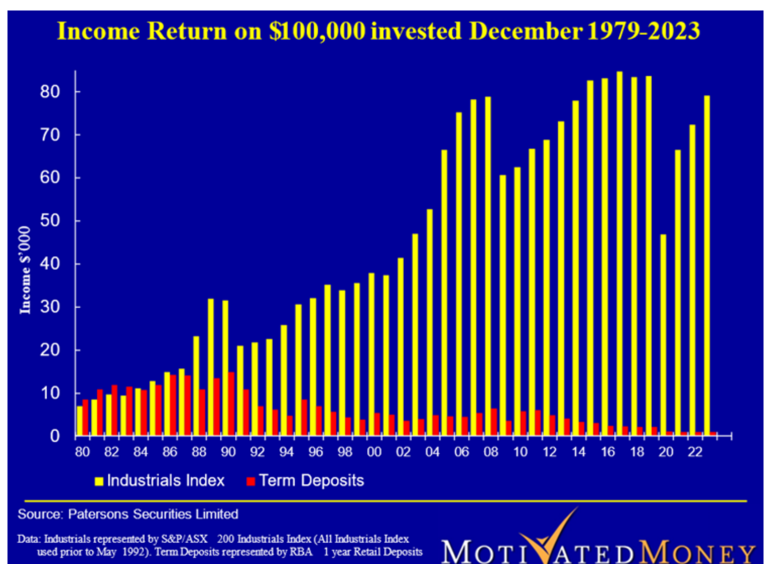
I feel for those people who are still using cash as a 'safe' haven for their money. It frustrates me that the industry I left in 2000 still uses volatility as a measure of 'risk'. Volatility is simply a function of liquidity; the ability to buy and sell shares on a daily basis.

The reason for fear is that share prices are the constant daily disturbing factor with shares whilst the cash flow is ignored. The result is to add cash, bonds, and property to a portfolio to smooth the returns.

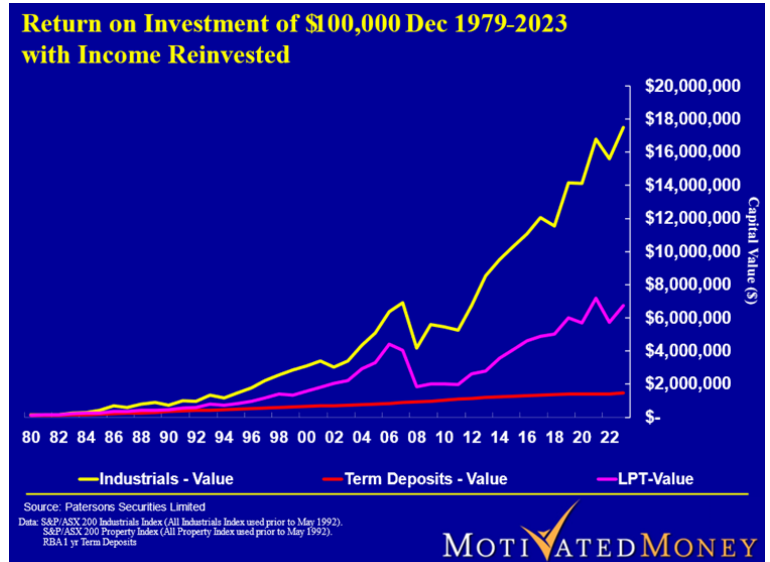
If you refer to the final chart below it compares shares, property and cash; the Industrials index, Listed Property Trust index and term deposits. So, the constituents of a 'balanced portfolio' looks something like this, with cash and property to reduce the overall volatility of the portfolio.







No one in all my years (50) in the industry has ever advised investors of the huge opportunity cost that this exacts. The result of this balance above means a return of roughly half what the industrials would have delivered.



Are you prepared to pay that?

Peter Thornhill is a financial commentator, author, public speaker and Principal of [Motivated Money](). He runs full-day courses in the major capital cities explaining his approach to investing "in the vain hope that not everyone is frozen with fear".

This article is general in nature and does not constitute or convey specific or professional advice. Share markets can be volatile in the short term and investors holding a portfolio of shares will need to tolerate short-term losses and focus on a long-term horizon, and consider financial advice.

CPI lowballs the true cost of living

Peter Martin

Why is Prime Minister Anthony Albanese suddenly so keen to deliver extra cost-of-living relief? One immediate reason is he is keen to make sure Labor wins the upcoming byelection in the outer-Melbourne electorate of Dunkley on March 2. But the cost of living wouldn't matter much for Dunkley – and it wouldn't matter much for the rest of us – unless it was really biting.

And despite what the Treasurer himself has been trying to tell us, it is biting.

Treasurer Jim Chalmers has been pointing out that in the June quarter and the September quarter (the three months to June and to September) real wages grew for the first time in years. By that he means that the wages index compiled by the Bureau of Statistics began growing faster than the consumer price index.

It's better than growing more slowly, but it tells us next to nothing about what's happening to buying power. Here's why.

Why CPI understates today's living costs

Way back in the late 1990s, more than a quarter of a century ago, the consumer price index (CPI) used to actually reflect the cost of living. It included all of the big costs incurred by households, including – importantly – mortgage interest payments. At the time, mortgages accounted for an average of $5 of every $100 each wage earner spent.

Then in September 1998, in response to representations from the Reserve Bank and the Treasury, the bureau changed the way it calculated the index. It excluded mortgage and other interest payments, in a decision it acknowledged would make the index worse at measuring living costs.

It still carries the warning on its website, saying the consumer price index is

> *not the conceptually ideal measure for assessing the changes in the purchasing power of the disposable incomes of households.*

The index actually does a pretty good job of measuring changes in living costs at times when mortgage rates aren't much changing. But at times when they are tumbling, it'll overestimate living costs. And when mortgage rates are soaring – as they have been lately – it will way understate what's happening to living costs.

We know by how much. For years, the bureau has also published a separate set of measures it pointedly calls "living cost indexes". These *do* include mortgage and other interest charges, and for households headed by employees (for whom the buying power of wages matters), they are substantial.

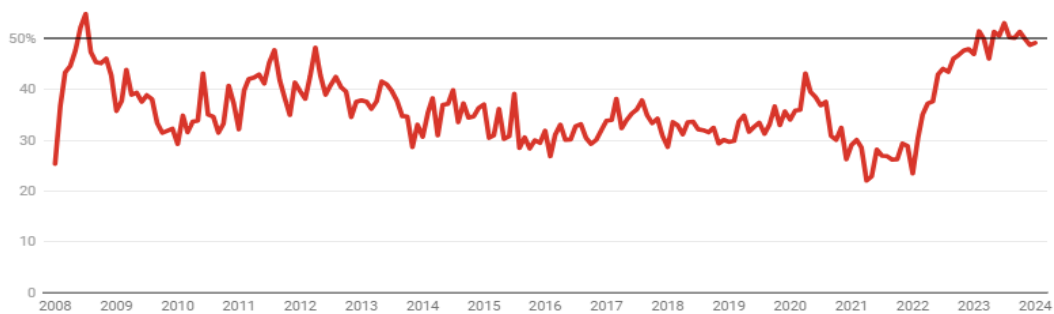
Living costs are up 9%

While the consumer price index (the one quoted by the treasurer) increased 4.1% for the year to December, the latest living cost index for households headed by wage earners climbed 9%. For these working households, the price of food climbed 4.8% in the year to September, the price of electricity 14.5% and the price of mortgage interest charges 68%.

It's the increases in mortgage rates that have made the increases in the other prices hurt so much. The overall increase in prices faced by wage-earners – 9% – is way above the typical wage increase of 4%. Bill Mitchell of the University of Newcastle points out that on this measure, the correct one, the buying power of wages has been falling for two and a half years. He says it puts the treasurer's comments in a wholly different light.

Why we should distrust the CPI

Working Australians are right to distrust the consumer price index, which is something the Australian Council of Social Service warned the bureau about when it made the change. Each month, the Melbourne Institute asks Australians whether their family finances have deteriorated over the previous year. Usually, about one-third of those surveyed say they have. But for more than a year now, around 50% of those surveyed have been saying their finances have got worse. That's a peak not seen since the global financial crisis, and one that has lasted longer.



Asked about family finances over the next 12 months, more than 30% say they'll worsen further. It's usually 20%.

Looked at from today’s perspective, the arguments put forward in 1997 for weakening the consumer price index as a measure of living costs are unimpressive.

Back then, the Treasury noted that many welfare recipients didn’t have mortgages and that a consumer price index that excluded them would better reflect their living costs.

The Reserve Bank argued interest rates were “conceptually different from other prices”. In any event, it wanted them excluded because it found it hard to use higher interest rates to bring down inflation if those higher rates pushed the measure of inflation up.

The change attracted little attention at the time, because mortgage rates weren’t moving much. By the time they did, the change had been bedded down.

But here’s some good news

For most of the time since the change, mortgage rates have either increased gradually or been cut, meaning the difference between what the consumer price index has been telling us and what’s been happening to us hasn’t been too stark. It’s been stark lately because interest rates have been rising quickly.

The good news – and there is good news – is that financial markets expect rates to begin falling this year, with the next move down.

Inflation as measured by the consumer price index (inflation excluding mortgage rates) is already falling.

Monthly and quarterly consumer price index

Percentage increase in the consumer price index in the previous 12 months

Source: ABS • Get the data • Created with Datawrapper

It makes now a particularly good time to announce measures to address the cost-of-living crisis. We need them because we really are in something of a crisis. Things are a lot worse than the official index suggests.

And there’s a chance that soon they’ll begin to get better, allowing the prime minister to claim a win.

Peter Martin, Visiting Fellow, Crawford School of Public Policy, Australian National University

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The latest trends in SMSFs

Derek Gascoigne

To do it yourself or not, is often a question we hear when it comes to superannuation. There’s no right or wrong answer, it is an individual decision. When taking the step to set up an SMSF or to wind an existing SMSF down, it’s important to understand both the benefits and costs.

According to ASFA, as at June 2023, Self-Managed Super funds (SMSFs) accounted for just under 25% of total superannuation assets (listed in the below table as "Funds with less than 7 members"). There is undeniably a place for SMSFs and, for some, they can be the only way to hold certain assets within a superannuation environment. They suit people who want to be quite ‘hands on’ with their superannuation and who are comfortable with the level of responsibility that comes with a SMSF.

Overview

Type of fund	Total assets ($billion)	No. of funds	No. of accts (March 2023)
Corporate	57	9	0.2 million
Industry	1,198	22	13.1 million
Public sector	668	31	3.0 million
Retail	690	72	6.5 million
Funds with less than 7 members	878	611,670	1.1 million
Balance of statutory funds	50		
Total	**3,541**		**24.0 million**

Source: APRA Statistics – June quarter 2023

The issue of costs

The first thing most people want to know is the cost. The way in which fees and costs work within SMSFs is similar to other types of super but they tend to vary more. SMSF costs can include yearly independent audits, asset valuations, and legal fees if the fund deed needs amendments. Depending on the assets in the fund, as well as any professional financial and investment advice received by the trustees, the running costs can generally be between $1,500 and $10,000 per annum, and this may even be before the management costs of any underlying assets or investments.

In a managed super fund, the costs of running the fund and operating its investments are often pooled and spread across all the members, generally resulting in a lower 'per head' cost that is largely predictable.

Some people choose to take a hybrid approach where they have both a SMSF and a managed fund. If you choose this approach you'll be paying fees on each, so you'd want to have a good reason to do this.

Who's responsible?

Another question is around responsibility - who is responsible for investment decisions and keeping the fund compliant (to avoid fines and other penalties). For an SMSF it's the trustees, but the depth of expertise in these areas depends on the individuals involved and many trustees do need guidance.

In a managed super fund this is all taken care of. Managed super funds can invest at scale, keeping costs low while also opening investment opportunities not necessarily available to the average investor, for example exposure to unlisted assets like infrastructure that can be an attractive diversifier and well aligned to long-term investing, or niche investment strategies managed by experts. Members of managed funds can often choose from a wide range of investment options and still be very active in managing their investment strategy if they choose to.

Insurance and other issues

When it comes to insurances, the trustees of a SMSF are responsible for sourcing, updating and paying for their own personal insurance cover (death, disablement, income protection). Managed super funds offer group insurance policies that are typically very competitive with other offerings from insurers. Of course, rates do vary and can be influenced by the composition of the membership.

Having an SMSF does throw up other complexities, for example for a couple managing an SMSF, divorce and separation can present a raft of legal and financial issues to ensure ongoing trustee obligations are maintained, where superannuation arrangements can be simplified by transferring to a managed super fund. Also, if a trustee becomes ill or passes away, it could change the obligations and responsibilities of the remaining member/s, issues that are generally avoided by members of a managed fund.

Latest SMSF trends

At UniSuper we've seen trends emerging in those taking up and giving up SMSFs. The average age of UniSuper members rolling out to an SMSF is age 50, while the average age of our members who roll money in from an

SMSF is age 62, and with an ageing population we are seeing more members rolling in from their own SMSF. Over time, the SMSF members' financial goals and their desired level of involvement in managing investments may change or wane, or the original purpose for creating the SMSF may no longer be necessary, for example if the asset that it was specifically set up to own is no longer held within the fund. In our experience, some people start to ask if this is how they want to be spending their time.

As you can see, there's a lot to think about if you are considering setting up or winding down an SMSF. The best bet is always to seek professional advice and understand the pros and cons of these options to set you up for the future you aspire to achieve.

Derek Gascoigne is State Manager Advice at UniSuper, a sponsor of Firstlinks. Please note that past performance isn't an indicator of future performance. The information in this article is of a general nature and may include general advice. It doesn't take into account your personal financial situation, needs or objectives. Before making any investment decision, you should consider your circumstances, the PDS and TMD relevant to you, and whether to consult a qualified financial adviser.

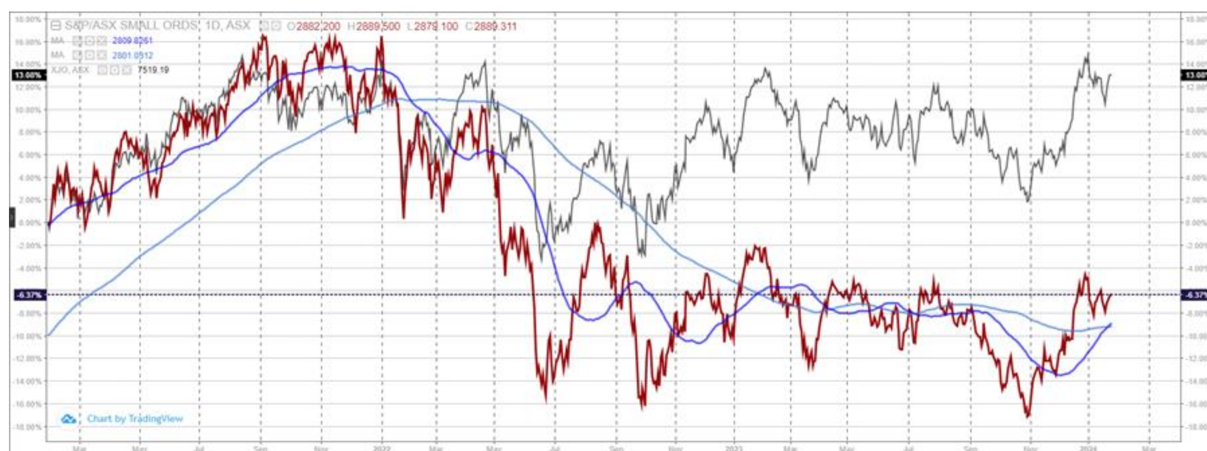
For more articles and papers from UniSuper, click here.

4 ASX small caps poised for a big year

Romano Sala Tenna

Despite the often-cited narrative, large caps actually out-perform small caps in Australia over the long term. But at different stages of the equity cycle, small caps come into their own and out-perform the broader indexes. This normally occurs where:

1. Large caps have appreciated to the point where valuations are stretched.
2. The 'animal spirits' (aka market confidence) return such that investors are prepared to take on more risk.
3. The economic cycle is constrained, and hence provides limited growth across the broader market (large caps).
4. There has been a period of relative under-performance with small caps.



Above: Small Caps have underperformed the ASX200 by ~20% over the past 3 years (IRESS)

Some of these conditions are now in place, and whilst we haven't seen any concrete 'evidence' that a re-rating is afoot, we are starting to see small caps increasingly mentioned in the media and by professional investors. This means that it's time to do the work and ready the list, in the event that this segment begins to move.

Portfolio approach

Small caps are where fortunes are made and lost. But it is the latter that is often overlooked. Investing in smaller companies has a higher risk for a host of reasons:

- The companies often have a shorter operating history.
- There is likely to be less diversification across clients, geographies and operations.

- Research coverage is often sparse, if it exists at all.
- Corporate governance can be on the skinny side.
- Stocks can get lost in the market; for example, there is only one BHP, but there are nearly 2,300 'small caps' all vying for attention.
- And of course, liquidity can be dangerously light.

Accordingly, investors should take a 'portfolio approach' when investing in smaller companies. This means spreading the designated capital amongst a portfolio of stocks to spread the risk. Irrespective of an investor's expertise or experience, losses are inevitable. The focus is to choose a mix of quality emerging companies so that the overall portfolio generates an appropriate return. Small cap investing requires a shotgun, not a rifle.

The Katana portfolios currently hold in excess of 55 stocks. Most of these companies are in the ASX100 or ASX200. However, where we see a particularly lucrative risk-return proposition, we are prepared to back our work and take on smaller companies.

Recently, we have been buying four companies in the smaller end of the market.

Praemium Limited (PPS)

There are just under a dozen platforms on the market of any size, and PPS's SMA and Powerwrap are collectively the 8th largest. Importantly, PPS is one of the 3 challenger players along with Netwealth and Hub24. And despite its size, PPS regularly ranks 4th for net inflows (in absolute, not relative terms).

The platform industry is a scale game. There is considerable operating leverage and every incremental dollar of funds under administration (FUA) disproportionately impacts profitability. PPS has around 2.5% of the market, yet it has a market capitalisation of <$200 million (or an enterprise value of just ~$160 million if we include the $40 million cash on the balance sheet). Netwealth and Hub 24 have approximately 3x the funds under management,, yet they are trading on valuations that mean their market capitalisations are 25x and 20x that of PPS.

It has taken Netwealth and Hub 24 the better part of a decade to get to where they are. Acquiring PPS would grow FUA by more than a third in one relatively quick and easy transaction. It is not surprising therefore that in November 2021, Netwealth lobbed a $1.50 bid for PPS. For a variety of reasons, a deal was not consummated. However, at the current price of 38 cents, it would be hard to see that both Hub24 and Netwealth would not be running the ruler over PPS.

Pepper Money Limited (PPM)

PPM is one of the best risk-return opportunities across our entire stock universe.

Anecdotally, there are some factors that indicate strong management, culture and operational excellence. For example, PPM has won the award for *Best Specialist Lender* for the past 11 years consecutively. Out of a field of several hundred, they have also been awarded *Best Non-Bank Lender* in 2017, 2019 and again in 2021 and 2022. In 2023 alone, PPM won a total of 11 awards.

On the distribution side, the PPM brand is well known and respected by mortgage brokers who have more than 22 years of distributing their products. Channel checks confirm that PPM is known for fast turnaround times, consistency, and great customer service. This has led to more than 20,000 brokers distributing their product - and this figure is growing by the month. In addition, Pepper has close to 40 white label partnerships with third parties (also increasing). This captive market now accounts for 45% of originations.

Prior to the 13 rate rises, PPM averaged an AUM growth of 21.3% per annum for 8 years. And considerably more at the bottom line, due to the operating leverage in the business. As the banks continue to retreat from asset financing and impose ever tightening criteria on home loans, non-banks such as PPM are well positioned to continue to grow market share.

Companies with high calibre management, strong growth rates and a consistent, definable strategy, normally trade at high double-digit earnings multiples. But the hysteria around cyclical fluctuations in net interest margin and loan volumes, has seen the stock sold down from its IPO price of $2.89 to the $1.30 level. Consensus PER is now 5.5x, and the net tangible asset backing is approximately $1.50 per share.

West African Resources Limited (WAF)

We are not aware of any 200,000 ounce per annum low-cost gold producers trading on a market capitalisation of less than $1 billion. For the 2023 calendar year, WAF produced 226,000 ounces from its Sanbrado mine at an all-in sustaining cost (AISC) of US$1,126 per ounce. This generated not only a significant paper profit, but more importantly strong operating cashflow. This factor alone justifies a notably higher valuation.

But the real appeal for Katana is the rapidly developing Kiaka gold project south of Sanbrado. This is a mid-scale but world class, low strip, open pit development. Company releases confirm a 19-year mine life averaging 220kozpa. With first production slated for the 2nd half of 2025, this will elevate combined production to >400,000 ounces per annum. On the current market capitalisation, this seems an excellent risk-reward opportunity.

As with every company (and especially smaller ones) it is important to understand why we believe it is 'mispriced'. In the case of WAF, the market would appear to be concerned with two issues: 1) funding and 2) country risk.

In the case of the first issue, WAF have repeatedly stated that they are fully funded to first production and do not need to raise capital. As a worst case, if they need/choose to raise, it is unlikely to be more than $100 million to $200 million; which is a modest 10-20% of the current market cap. So not material, even in the "worst case scenario".

With respect to Burkina Faso (country risk), there are superficially some valid concerns around sovereignty. But what investors may not be aware of is that:

- West Africa is now the largest gold producing region globally.
- Burkina Faso is the 2nd largest producer in West Africa.
- Burkina Faso is ranked #1 for gold discoveries over the past decade.
- The country is also ranked #1 globally for permitting times and construction costs.

Integrated Research Limited (IRI)

At a $54 million market capitalisation, this is a micro-cap in every sense. And given its erratic liquidity (turnover), this stock is not for the novice investor, trader, or anyone with a short time horizon.

We have tracked IRI for more than a decade, and as this short extract below illustrates, the price has experienced wild gyrations. Post covid, the stock rallied as high as $4.80, before plunging in early 2022 to the 30 cent mark. But over the past 18 months, the stock price has mapped out a clear accumulation phase. We are now awaiting a break-out to confirm that it is time to meaningfully re-build our position.

IRESS

As with all stocks in the Katana portfolio, we look for the fundamentals and technicals to align. And there are signs that this is finally occurring, with IRI recently releasing a positive trading update for the 1st half of FY24. Statutory revenue, EBITDA and EPS were all up on the previous corresponding period. Importantly, net cash (there is nil debt) also grew to $21.5 million, which represents nearly 40% of their market capitalisation.

Research coverage is almost non-existent, but one of Bell Potter's most respected analysts covers the stock and the broker has historically had a good handle on their operations. Their most recent note places IRI on a PER of 5.3x and they have increased their price target to $0.66 per share.

Romano Sala Tenna is Portfolio Manager at [Katana Asset Management](). This article is general information and does not consider the circumstances of any individual. Any person considering acting on information in this article should take financial advice.

Past performance is not a guarantee of future performance. Stock market returns are volatile, especially over the short term.

Passive investors exposed to bubbliest market segment

Eric Marais

An intuitive but flawed understanding of passive investing would suggest that, out of 100 active portfolios, an index tracker will come in 50th place. In other words, half the active managers outperform, half underperform, and the benefit of indexing is that you'll avoid the bottom half and get a roughly average result at very low cost.

2023 shows that's not quite true, as we can see in the distribution of this year's returns. In a Monte Carlo simulation, had 100 investors picked 50 equal-weighted stocks at random from the MSCI World Index at the start of the year, a remarkable 92 of those portfolios would have trailed the Index.

In reality, global equity funds did better than just picking stocks at random. Still, the Index managed to beat 73% of active managers—a feat only topped during the build-up to the tech bubble in the 1990s.

What happens next?

That was a clear victory for passive investors in 2023 over us and most of our active peers. But there's a deeper implication: if you're buying a passive fund to guarantee an average result, that's not necessarily what it'll deliver.

2023 was an outlier on the positive side, but if a passive strategy can deliver a 92nd percentile result, then an 8th percentile result is also possible. That kind of outcome isn't just theoretical. A passive strategy lagged nearly all simulations as recently as 2009 (3rd percentile) and, before that, in 2000 (2nd percentile).

A passive approach, it turns out, is a distinct portfolio with its own risks and exposures. It moves up and down the performance rankings like any active manager, with one critical difference: how the portfolio is constructed. While we build portfolios based on shares that we believe offer the most attractive value, traditional market capitalisation weighted passive funds allocate strictly according to index weighting, paying no mind to value or risk.

Imagine an investment universe that consists of five equally valuable companies, but one is priced at twice its fair value and the other four are priced at half. While the value-conscious manager would look to avoid the overvalued stock altogether, the passive approach would allocate half its capital there.

By design, traditional index funds are naturally overexposed to the most overvalued parts of a market. It follows that the *environment where a passive approach will rank highest versus peers is one where the most overvalued shares get even more overvalued.*

Indeed, the more the valuation gap between overvalued and undervalued stocks widens, the more the passive strategy outperforms, the greater its allocation to the overvalued stocks, the more money it attracts to keep the cycle in motion—and the riskier it becomes.

The converse is also true: *the environment where a passive approach will do worst is one where the most overvalued shares sell off hardest (e.g. 2000) or the most overlooked shares recover most strongly (e.g. 2009).*

As a barometer of current market conditions, this year's 92nd percentile performance from the Index is a fascinating tell—one that chimes with our work on aggregate valuation gaps as well as our bottom-up research.

The Magnificent Seven versus the rest

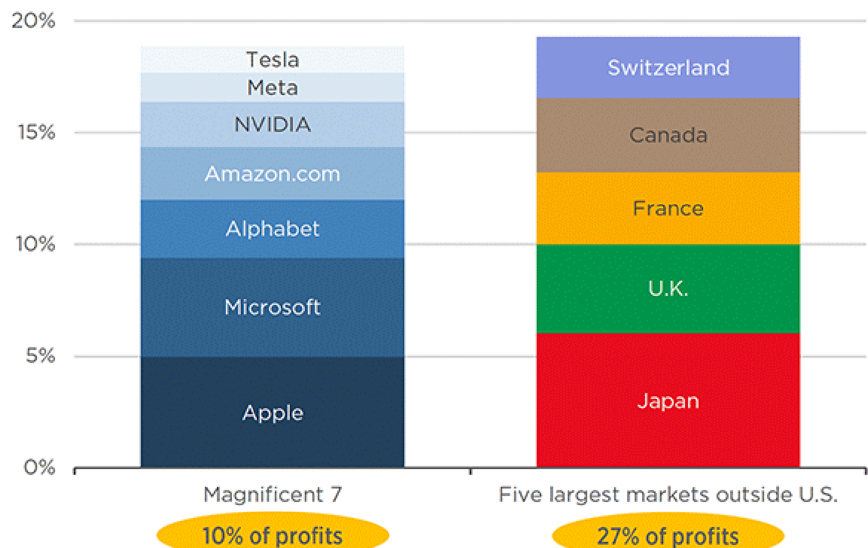
And 2023 isn't alone. Though 2022 was a break from the recent pattern, US index-tracking strategies have now beaten the combined wisdom of active investors for 8 out of the last 10 years. The scope and length of that remarkable run now eclipses even that of the dotcom boom.

Never before has following the crowd made so much money. Nor, in our estimation, so little sense. But just look at the opportunities the crowd has left for those of us willing to take a different view.

We could wax lyrical about the glaring difference in value between Korean banks priced at 4 times earnings, versus Apple at 28 times, despite diverging fundamentals—Apple is increasingly at risk of bans in China, while Korean banks could double their dividends.

Or how the thick margin of safety at Intel, backed by listed stakes and real saleable assets, compares to the slim margin for error at Nvidia, trading at 13 times next year's projected revenue. That revenue that could be competed away over time, while Intel's semiconductor "fabs" in the US are increasingly valuable as the east and the west drift further apart.

We could effuse about the quality of Nintendo's innovation engine, and marvel at Mr Market's willingness to extrapolate dominance for the Magnificent Seven while putting little value on Nintendo's exceptional intellectual property.



But those deep dives would only cover a fraction of the portfolio, which risks diluting the message on how distorted the overall opportunity set has become.

Not since the inception of the first Orbis Funds in 1990 has one country's benchmark weight punched so far above its share of global GDP (then Japan, now the US). Nor since our sister company Allan Gray's creation in 1973 have a handful of shares commanded such a large proportion of the market. Today, the Magnificent Seven stocks command as much market value as the "Foreign Five", the largest developed stockmarkets outside the US by market value, yet the Seven contribute less than half the profits of those stockmarkets.

1 This is the asset-weighted net-of-fee return of all share classes in the Strategy. This return may differ from the return of any individual share class.

This is an extract from Orbis Global Equity's December Quarterly Commentary.

Eric Marais is an Investment Counsellor at Orbis Investments, a sponsor of Firstlinks. This report contains general information only and not personal financial or investment advice. It does not take into account the specific investment objectives, financial situation or individual needs of any particular person.

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Why is land lease housing booming?

Cameron Murray

At first glance the land lease business model appears like a way to get cheap housing that is also a good investment. But regulatory quirks mean we all pay.

One of the hottest plays in residential real estate investment is the land lease community. Currently, this model of ownership houses 130,000 Australians and there are many more projects in the pipeline.

So what's it all about?

This article is my attempt to wrap my head around the business model and understand where the rabbit goes in this financial magician's hat—because if it is a cheaper option for residents, then how is it also a better investment for landlords?

Who exactly is paying?

The land lease model is essentially that of a caravan park. In Queensland, the relevant legislation for these communities is the *Manufactured Homes (Residential Parks) Act 2003*, with each state having its own legislative framework. Some land lease communities are (or were) caravan parks. In the United States land leases are called 'manufactured home estates'.

Many companies are active in this sector, such as Ingenia, GemLife, Hometown, Palm Lake, and Sea Change. Large institutional investors are also taking an interest.

Halcyon is a big player and was recently acquired by Stockland for $620 million. There now seems to be a huge financial appetite for investment in this model, just as there is for build-to-rent apartments.

Here's how they describe the land lease model:

…you purchase your stand-alone home and sign a lease (Site Agreement) to pay rent (Site Fees) on the freehold land on which your home sits. The land remains the property of Stockland. Under the legislation (relevant to the state the home is located in), you hold your land lease in perpetuity, meaning it lasts the life of your ownership. The Site Agreement is your contractual right to occupy the land and also gives you non-exclusive use of the community's common areas and communal facilities.

This site agreement style of lease comes with the obligation of an ongoing rent payment, which is often a different amount for singles and couples. Some are perpetual leases, but others expire after 50 or 99 years, and the site agreement can be traded like any other property right. There is usually no subletting allowed.

Because of this lease arrangement, rather than a property title, there is currently no way to borrow money to buy a home and lease bundle in land lease communities. So they are typically marketed towards retirees, with often minimum ages of 50 years and bans on children residing in the community.

They are essentially retirement villages. And I think that much of the analysis that follows applies to retirement villages in general.

Land lease communities seem to be delivering for many residents. They also seem to be delivering for investors.

If land lease projects make better returns for developers and landlords, how can they also be cheap for residents compared to buying or renting freehold property?

Regulatory quirks relied on for the business model

Here's how Stockland explains its land lease business model.

In the development phase, land lease projects are like any other freehold development project, but what is sold are called site agreements, not freehold titles.

In the ongoing asset ownership and management phase, land lease projects look like any other build-to-rent project.

How does this lease arrangement enable a housing project to earn sales revenue *and* rental returns while still being of value to residents?

Tax and welfare quirks

As the Halcyon website explains:

You may be eligible for rent assistance if you receive a pension through Centrelink. This can reduce your Site Fee by around $60 a week. (Your Site Fee is subject to an annual CPI adjustment or a yearly formula review to factor in any extraordinary rises in government charges, such as rates). A market review of your site rent takes place every three years.

The trick here is that although owning a site agreement means you 'own' your home, it is also classified as a lease. So pensions get extra money to 'own' this type of home because the welfare system pretends that they are renting it instead.

Currently, rent assistance is $174 a fortnight (maximum) for an age pensioner couple household. For a typical land lease, with a $250 per week 'rent', that covers about 35% of the ongoing cost. There are no other management costs for shared facilities, as these are wrapped up in this one rental amount.

Which is a little weird. Why can't apartment owners just rename their body corporate fee a lease? You would own the physical apartment, but not the 'land' and then rent the land from the body corporate at a rate that covers exactly the same things as a body corporate fee.

Another quirk is that land value taxation is assessed on the total project as a single site. In practice, this means the per-dwelling land value is much lower than comparable freehold properties. A few quick and dirty calculations using land valuations from QLD Globe suggest the land value assessment for some estates is between $30,000 to $80,000 per dwelling, whereas nearby homes (admittedly on larger lots) have assessed land values at $200,000 to $400,000 per dwelling. For a landlord, this is a huge tax benefit compared to owning a physically near-identical housing estate that was individually freehold titled. Such benefits of lower land value rating can extend to also to lower council rates, which are charged to the landlord and recovered from residents in their site rent.

One big tax quirk is that stamp duty is also not payable on trades of site agreements. Even though site agreements can cost as much as nearby freehold property. So this further reduces the upfront cost of ownership for each resident by a few per cent, a gain that can be shared between landlord and resident.

There are a lot of labelling games in this business model.

Planning and physical quirks

Land lease projects look different. I'm picking on Queensland's biggest land lease landlord here, but check out the aerial imagery. Here's Halcyon Glades at Caboolture, Halcyon Lakeside at Bli Bli, and Vision by Halcyon at Hope Island on the Gold Coast.

Source: Apple Maps

I don't have to mark where these projects are because they are obvious from their much higher density than neighbouring residential estates.

I suspect but don't know for sure, that such densities would otherwise be uneconomical and also not allowable under local regulation. Streets are often exceptionally narrow and built to lower standards. This makes sense, as they are not public roads but internal driveways. Setbacks that would otherwise apply to detached housing do not apply, and generally much smaller homes of around 120-150sqm are built. Since older buyers generally don't value larger homes or backyards as much as younger buyers do, these design concessions don't seem to affect sale prices as much as they might in the broader market.

Controversially, land lease communities are often allowed in rural zoned areas, where legacy zoning laws for caravan parks apply.

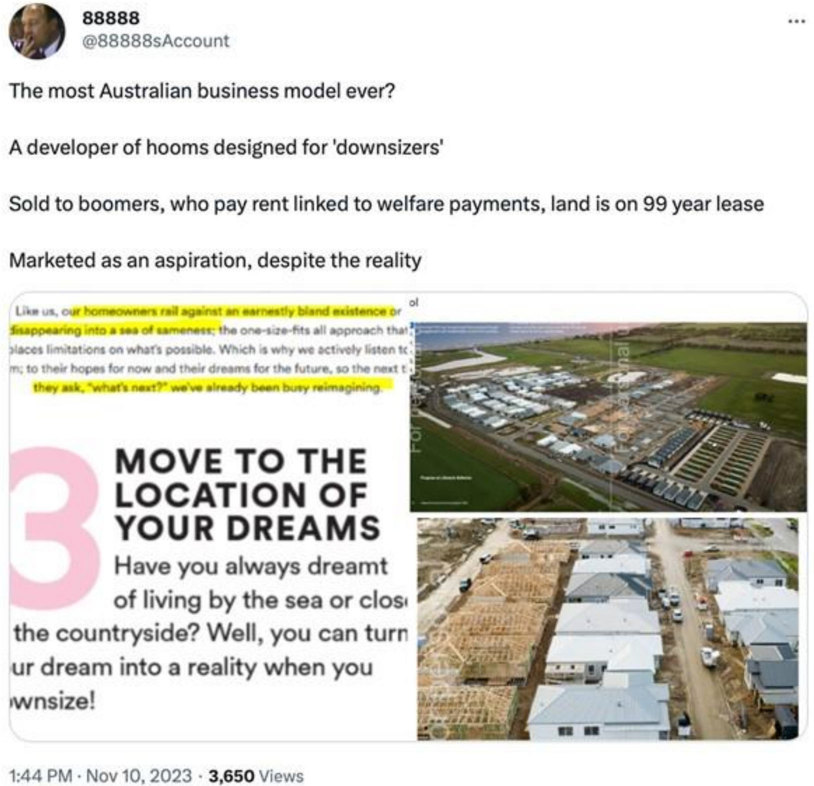
Taking advantage of these often-illusory differences between a land lease and a freehold subdivision makes financial sense. If you can get 300 land lease homes on a site when it is land leader, rather than a dozen rural housing blocks as freehold, you are way in front.

How much does it cost residents?

I was surprised that buying a site agreement in a land lease community is not cheap.

Here's a two-bed, two-bath 128sqm home on what looks to be less than a 200sqm lot, seeking "offers above $990,000" for a new site agreement with the dwelling included on the Gold Coast. Yet when I search online, there are nearly a thousand detached homes on the Gold Coast for a lower price, often in better locations with pools and large lots.

Many people are sceptical that land leases are cheap on a like-for-like comparison of size and quality, as this critical tweet noted.



I suspect that in terms of ongoing cost, a ballpark financial comparison for residents of freehold ownership, rental, and a land lease agreement, looks something like this.

Freehold ownership
Home price = $700,000 (including stamp duty) or $35,000 per year interest cost at 5%
Rates/insurance = $6,500/yr
TOTAL = $41,500

Land lease
Site agreement = $900,000 (no stamp duty) or $45,000 per year interest cost at 5%
Site fee = $13,000
Building insurance = $2,000
Minus rent assistance = $4,500
TOTAL = $55,500

Rental
Annual rent = $30,000
Minus rent assistance = $4,500
TOTAL = $25,500

So the premium is probably about $10,000-$30,000 per year above the alternatives. Typically, site agreements rise in value with the general housing market, so that makes it much better than renting.

This comparison ignores the services included. Some communities have free golf course access as part of the deal. Most have extensive community facilities and are usually gated and more secure than other alternatives. The simplicity of the package deal of bundling all ongoing costs and management into a single rent payment can be appealing and valuable, and it seems that residents value all of this at more than the $14,000 per year premium over owning a freehold house.

Who pays?

It looks like there aren't clear cost savings for residents, even after rent assistance and a lack of stamp duty are factored in.

Costs are often higher than owning a nearby freehold home. What you get for those higher costs are extra services and shared amenities, security and simplicity. From what I hear, there is often a great social and communal atmosphere. The trade-off is density (and sometimes less privacy) for services and community.

That's worth it for some people.

But all of us pay. If all of the 130,000 land lease residents got the full rent assistance amount (which they don't), that would be about $420 million of the $5 billion in annual rent assistance paid annually by the Australian government.[1]

Without this rent assistance, the value of these site agreements, and the ability to charge the usual $250 per week in site rent, would be greatly diminished.

Not surprisingly, the recent increase in rent assistance was reported as "a boost for land lease communities."

Investors also benefit from the physical flexibility of building smaller, cheaper homes, giving up less land for road circulation and so forth. The lower land value assessment helps with keeping ongoing taxes and rates down too.

One downside for investors is the lack of mortgages currently available, which limits their buyer pool. No doubt there are plenty of incentives out there to create a financial instrument that achieves the same outcome.

Future outlook and risks

One risk to tenants concerns the setting of rents. As the price of alternative rental and home purchase rises, there is nothing stopping rents within land lease communities from being increased to match.

This has been an issue historically. The relevant legislation has been updated and reviewed in the past decade in most states to curtail overly ambitious rental increases and problematic mark-ups from landlords on-selling electricity and other services within communities.

But broadly rising rents in the housing market mean that this is a concern again.

Overall, the business model seems to be built around the quirks of the tax and planning systems, meaning we all pay. As my Twitter friend pointed out, this is probably the most Australian business model ever.

[1] That's 40,000 households getting the $174 per fortnight couples rate and 50,000 single households getting the $184 singles rate (rent assistance rates from here).

Dr Cameron K. Murray is Chief Economist at Fresh Economic Thinking. The original article can be found here. Subscribe to his written work at Fresheconomicthinking.substack.com. This article is general information.

*His new book, **The Great Housing Hijack**, will be released on 27th February 2024 (you can pre-order now). If you want to understand the economics of housing markets and why everyone claims to want affordable housing, but no one wants cheap housing, this book is for you.*

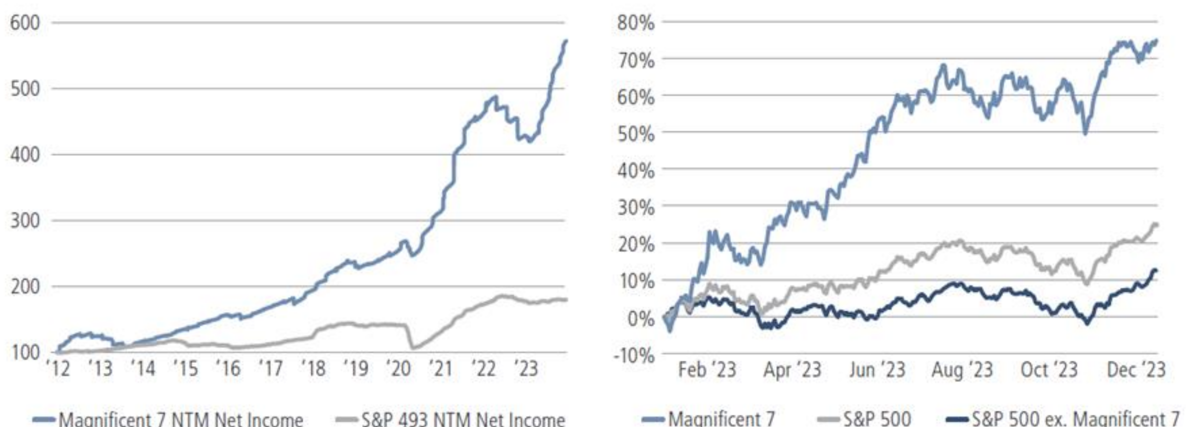
Challenges for the Magnificent Seven stocks

Raheel Siddiqui

Envy of the other 493 stocks in the S&P 500, the so-called Magnificent Seven—including Apple, Alphabet, Amazon, Meta, Microsoft, Nvidia and Tesla—wears extraordinary stripes. In the seven years prior to the Covid-19 pandemic, their collective top line grew at 15% compounded annually, versus just 2% for the rest of the index. Since 2020, the Mag 7 have increased sales by 16% a year.[1]

Even in a challenging growth environment, these heavyweights delivered impressively in 2023: The Mag 7's net income grew 34% versus 1% for the other 493 stocks in the index (see the left side of figure 1), and in a show of investor confidence, their collective P/E multiple expanded 30% compared to 9% for all the rest. As a group, the Mag 7 generated a 75% return for the year versus 25% for the S&P 500; without them, the broader index would have risen just 12% (as shown on the right).

Figure 1: The Magnificent Seven have dominated the other 493 names in the S&P 500 index



Source: FactSet. Data as of December 15, 2023. **Past performance is not indicative of future results.**

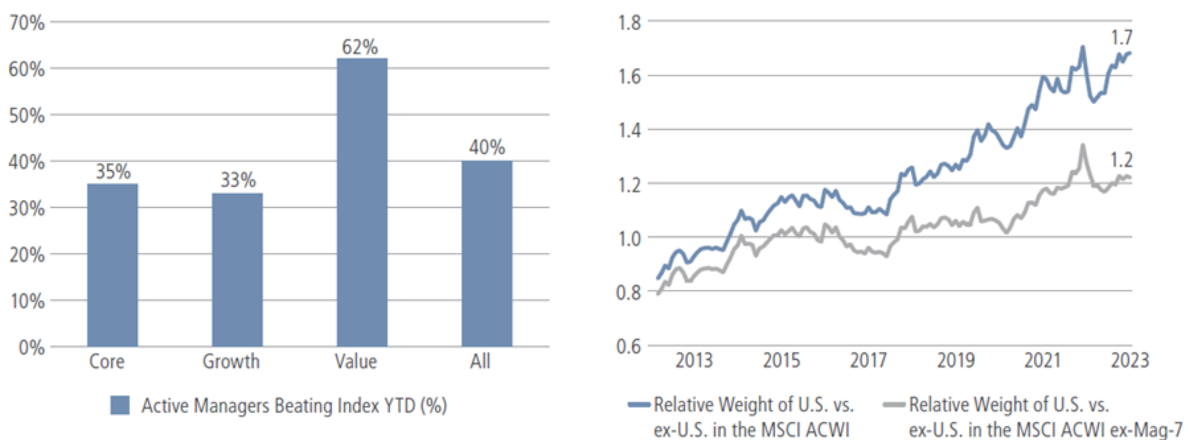
Big tech's influence on sector performance was palpable, too. Without these seven names, the Tech sector would have returned just 15% rather than 50%; the Communication Services sector, 7% versus 50%; and the Consumer Discretionary sector, 6% versus 33%.[2]

It has wider implications

We believe the collective heft of the Mag 7 has even broader implications for investors. The influence of this group—which now comprises nearly half the market-cap weight of the Russell 1000 Growth index and 28% of the S&P 500—has been boldly on display. In 2023, just one-third of U.S. core- and growth-oriented funds outperformed their Mag 7-heavy benchmarks, whereas nearly twice as many value funds outpaced their benchmarks, which don't include the Mag 7 (see the left chart in figure 2).

The Mag 7's influence spans geographical borders as well. The weight of U.S. equities in the MSCI ACWI index has risen to an all-time high of 63% from just 46% in 2013. Less appreciated, perhaps, is that fully a third of this increase is due to the rise of the Mag 7! As a result, the U.S. now accounts for 1.7 times the weight of the rest of the world combined; without the Mag 7, the figure is a more modest 1.2 (as shown on the right). Such a reduction in geographical diversification within the index, we believe, could have longer-term implications for asset allocation and risk management.

Figure 2: The collective heft of the Mag 7 has broad risk-management implications



Source: Left side: Lipper Analytical Services, BofA Equity & Quant Strategy; right side: FactSet. Data as of November 30, 2023. Past performance is not indicative of future results.

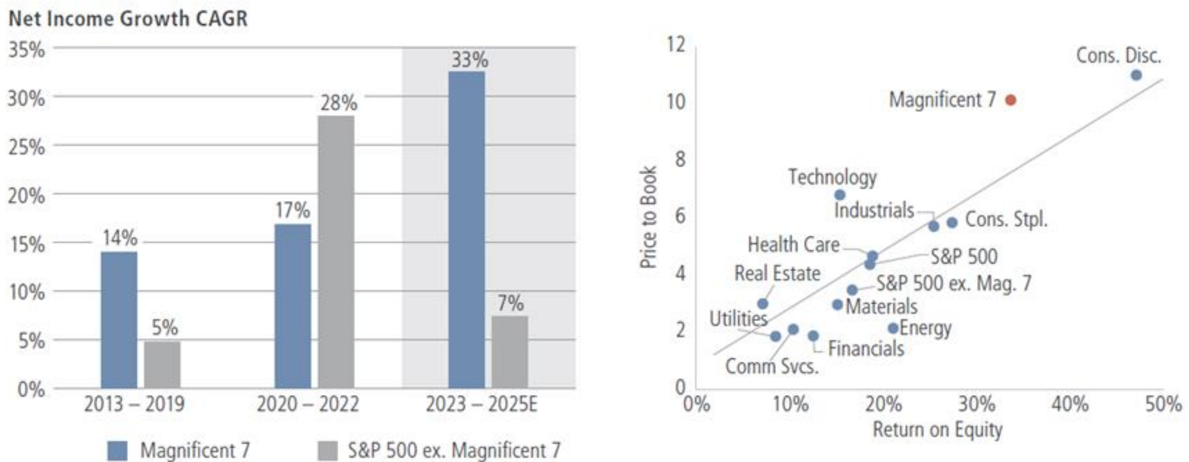
In light of their sheer size and influence, we expect the Mag 7 will continue to shake up active managers' scorecards relative to their benchmarks in 2024, and beyond.

All the glitters may not keep turning to gold

The Mag 7's achievements in 2023 notwithstanding, we fear these marquee stocks could face headwinds in the coming year.

First, valuations appear precarious, in our view. Wall Street expects the Mag 7's earnings and revenues to grow 33% and 17% per year, respectively, through 2025 (see the left chart in figure 3). Yet even considering the group's relatively high returns on equity (shown on the right), the Mag 7 has the unnerving distinction of being the largest and most expensive grouping within the S&P 500. At current valuations, we believe this group—which now represents more than a quarter of the S&P 500—is roughly 60% more expensive on a P/E basis than the rest of the index, making them potentially vulnerable to even minor hiccups in the coming year.

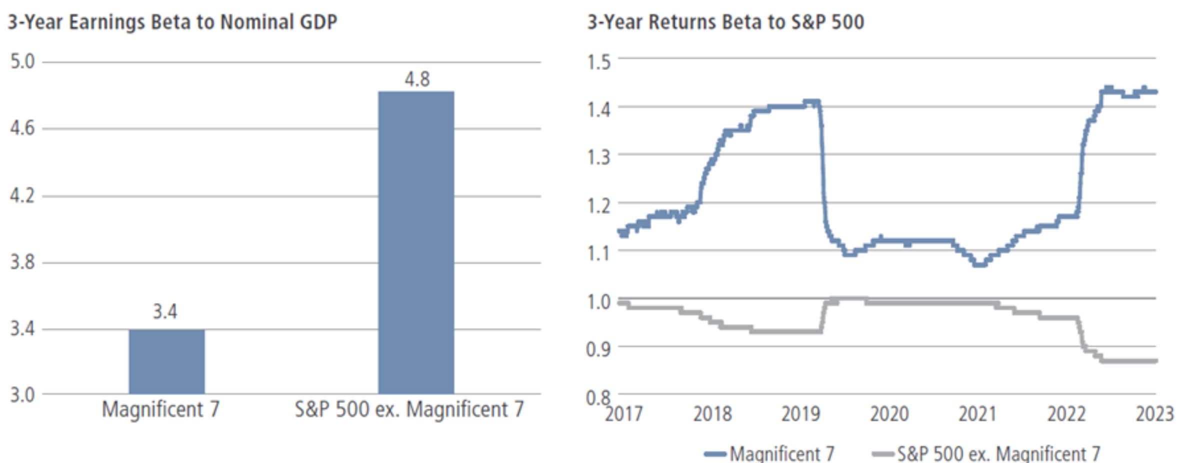
Figure 3: The mag 7's strong earnings expectations are commanding relatively rich valuations



Source: FactSet. Data as of December 15, 2023. Note: For the right-hand chart, data for the Technology, Consumer Discretionary and Communication Services Sectors are shown excluding the Magnificent 7 stocks. **Past performance is not indicative of future results.**

Second, the Mag 7 may prove more cyclical than investors seem to expect. These giants are often considered defensive businesses given that their products drive the relentless modernization of society, and that they also boast strong balance sheets and relatively high, stable profit margins. Indeed, over the last three years, the Mag 7's earnings beta to nominal GDP has been 30% lower than the rest of the S&P 500 (see the left side of figure 4); however, the price beta of these stocks—at 1.4—was 50% higher than the rest of the S&P 500 (as shown the on right).

Figure 4: The Mag 7 may be less defensive than investors anticipate



Source: Neuberger Berman Research and FactSet. Data as of December 15, 2023. **Past performance is not indicative of future results.**

Third, we believe the price returns of these seven stocks are highly correlated to each other—meaning that, from a portfolio perspective, owning them as a group is akin to inviting additional risk rather than diversifying away from it. Since 2017, the average pairwise correlation of the Mag 7 has been 55%—that's 70% higher than for the rest of the 493 stocks.[3] Furthermore, we find that correlation tends to rise during selloffs, which could make holding these stocks even riskier in a downturn.

Therefore—and despite some of their defensive characteristics—we fear that investors may have overlooked the inherent cyclicality and correlation of the mega-caps, potentially magnifying the investment risk should the Mag 7 begin to lose favour.

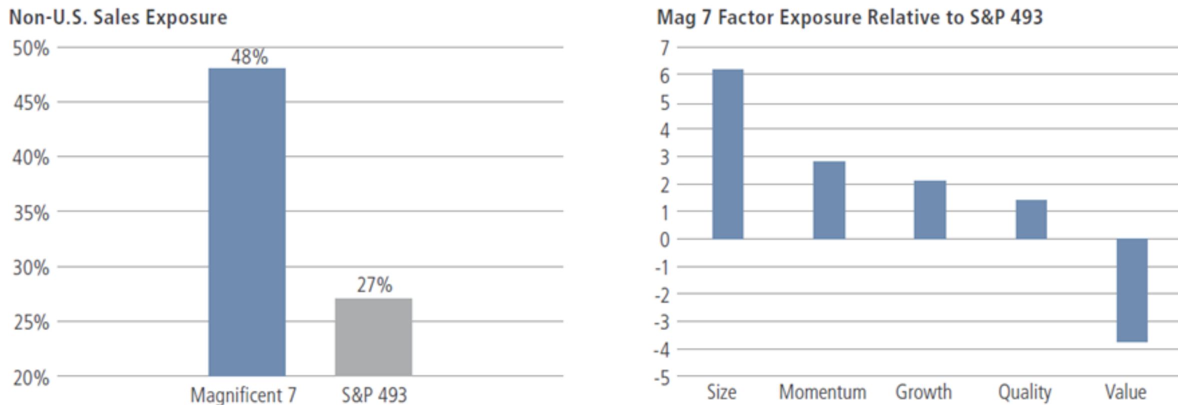
Other things to influence Mag 7's prospects

Looking at these stocks another way—through a factor lens—makes us conclude that overweighting these stocks is essentially a wager on specific factors that have contributed to their outperformance.

One of those factors is international exposure. As shown on the left side of figure 5, the Mag 7 derives roughly half of its revenues from outside the U.S., about twice the percentage for the average U.S. publicly traded

company. Adding the Mag 7 to an equity portfolio could increase its sensitivity to international growth—a potential benefit when the global economy is humming, but a potential drag in a broader slowdown.

Figure 5: Specific factor exposures may determine the Mag 7's outperformance



Source: Neuberger Berman Research and FactSet. Data as of December 15, 2023.

Additional factors may determine the Mag 7's performance in 2024. Specifically, and relative to the index, the Mag 7 are rich in size, quality, momentum and growth factors, and outperform when these factors are in vogue. As noted in our previous 4Q 2023 Equity Outlook, these factors tend to be rewarded when economic growth slows—as it did in 2023—while being relatively shunned in favour of small size, lower earnings quality and high value when growth eventually rebounds.

[1] Source: FactSet. Data as of December 15, 2023
[2] Source: Strategus. Data as of December 5, 2023
[3] Source: Neuberger Berman Research and FactSet. Data as of December 15, 2023.

Raheel Siddiqui is a Senior Research Analyst, Global Equity Research at Neuberger Berman, a sponsor of Firstlinks. This information discusses general market activity, industry, or sector trends, or other broad-based economic, market or political conditions and should not be construed as research or investment advice. It is not intended to be an offer or the solicitation of an offer.

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