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Contents

Editorial

I thought I knew everything there was to know about the world's greatest-ever investor, Warren Buffett - it turns out that I was wrong.

There are thousands of books on Buffett, outlining how he was mathematically gifted as a child, how he studied economics and business at Columbia University and the University of Pennsylvania, how he joined the firm of his idol, Ben Graham, out of university, how he formed his own investment partnership at age 25 and went on to crush the market (achieving 32% annual returns vs the Dow's 9% over 11 years), and how he bought into Berkshire Hathaway and expanded it into a now US$1 trillion company, with famous investments in the likes of American Express, See's Candy, Washington Post, Coca-Cola, and Apple.

Buffett has also been incredibly generous with his knowledge in his Berkshire shareholder letters since penning his first one in 1977.

Yet a new book manages to break new ground on Buffett and unearth some hidden gems. Brett Gardner, in *Buffett's Early Investments*, looks at 10 of the companies that Buffett invested in between 1950 and 1966, when he was in his 20s and 30s. In a unique twist, Gardner analyzes each of the companies using only the financial information that was available to Buffett before he bought them - annual reports, analysts' research, manuals of corporate financial data, and other little-known sources. Gardner did this because he wanted to understand why Buffett invested in these stocks, and why many of them turned out successfully.

The 10 investments that Gardner profiles are Marshall-Wells, Greif Bros. Cooperage, Cleveland Worsted Mills, Union Street Railway, Philadelphia and Reading Coal and Iron, British Columbia Power, American Express, Studebaker, Hochschild, Kohn & Co., and Walt Disney.

Five of the investments were made during Buffett's investment partnership from 1957-1969, and the other five were from before that time.

Let's look at one of these bets in detail because I think it had a large influence on Buffett's investment philosophy and why Berkshire Hathaway is set up the way it is.

Philadelphia and Reading Coal and Iron

Philadelphia and Reading was an anthracite coal company. Anthracite coal was central to America's energy production up until the early 1900s. At its peak, it contributed about 20% of the country's energy output. Yet competition from more efficient energy sources, including other types of coal, resulted in hard times for Philadelphia and Reading. The company had filed for bankruptcy on multiple occasions, including in 1937.

Philadelphia and Reading was run by local businessmen. They owned few of the company shares and they continued to invest cash (unwisely) into the barely breakeven coal business.

That didn't stop Buffett from buying shares in the company in 1952. At the time, Philadelphia and Reading was US$19 per share. The stock then fell to US$9 per share. This didn't seem to faze Buffett because he proceeded to buy more of the stock. By 1954, the company had a market capitalization of US$18 million – it was tiny. However, Buffett had made it his largest personal position, having invested US$35,000.

At first glance, the company's financial statements didn't make for pretty reading. Revenue had dropped by 40% over the previous five years, and profit had deteriorated to almost zero.

But it was in the balance sheet rather than the profit and loss statement where Buffett saw value. The company had net assets of US$9 per share and Buffett estimated that it had off-balance sheet assets of US$8 per share.

Thus, Buffett was buying at close to US$9 per share, when he thought the company was worth almost double that.

That's only half the story, though. It turns out that Buffett's mentor and investment idol, Ben Graham, was on Philadelphia and Reading's board – which is how Buffett is likely to have become interested in the stock in the first place. Like Buffett, Graham had stated buying the company's stock in 1952.

In 1954, a group of investors from Baltimore bought more than 11% of stock in Philadelphia and Reading and they sought an alliance with Graham and his partner, Mickey Newman. Both parties were unhappy about the company continuing to invest in the coal business. Newman had also detected significant tax losses on the company's balance sheet which could be used to acquire profitable businesses whose income would be shielded from future taxes.

Obtaining three of nine board seats, the alliance set about transforming the company. They changed the company's name from Philadelphia Reading Coal Iron Company to just Philadelphia Reading Corporation. Newman then did a private deal to buy Union Underwear, the country's largest manufacturer of men's and boys' underwear, operating as a licensee of the Fruit of the Loom trademark.

The other board members were infuriated by the deal and it went to a shareholder vote. The stockholders approved the purchase.

Philadelphia and Reading paid US$15 million for Union Underwear, which was earning US$3 million in pre-tax profits. Those profits would be partly shielded by the tax losses of Philadelphia and Reading. And the deal was struck on highly attractive terms, using US$9 million from a non-interest-bearing loan.

Soon after, Graham became the company's Chairman, Newman its President, and it appointed the former head of Union Underwear as its CEO. Thus, the group obtained full control of Philadelphia and Reading.

The company then acquired Acme Boots for US$3.2 million at a valuation of just 4x earnings. Again, much of the purchase was financed with non-interest-bearing debt.

By 1956, the company was earning US$7 per share.

Newman and Graham ended up making numerous purchases of cheap companies, including the aforementioned Fruit of the Loom. And Newman eventually bought 73% of the company in 1965 for about US$64 million (valuing the whole company at US$88 million). That compares to the company's $18 million market cap when Buffett was buying in 1952-1954. However, it's not known when exactly Buffett sold his shares in Philadelphia and Reading.

Two footnotes to the story. The first is that Berkshire Hathaway ended up buying Fruit of the Loom and still owns it today. The second is that it isn't hard to see the similarities between Philadelphia and Reading and Berkshire Hathaway, a struggling textile mill that Buffett started buying in 1962 and took full control of in 1965.

Four factors behind Buffett's early success

Gardner goes into detail on the other nine investments, and the opportunities that Buffett saw in them. From illiquid asset plays like Union Street Railway to investing in the visionary leadership of Walt Disney (and selling out too early after Walt died) to backing a great company in American Express hit by a temporary scandal, the book shows Buffett's willingness to be bold and take big bets, to have the patience to see many through, and to be ruthless when necessary, as he was with management when taking over Berkshire Hathaway.

Gardner concludes that Buffett's success early in his career came down to four factors:

1. Activism. Buffett wasn't afraid to take significant stakes in companies and then push for management changes to bridge the gap between the stock price and its underlying value.
2. A concentrated portfolio. Buffett was confident enough to make large purchases in companies he knew were undervalued. For instance, American Express became 40% of his investment partnership at one stage. Not many fund managers would have the brass to do this.
3. His extensive research. Buffett read voraciously on companies, he talked with management, and he visited factories. He wanted to know everything about the business before investing.
4. Filtering ideas. While well-read, Buffett was also able to simplify industries and companies and figure out their key drivers.

**Gardner's book has been released in the US and is due for release in Australia next month.*

My article this week looks at the challenges of building a dividend portfolio with ASX 200 dividend yields hitting near 25-year lows. I explore several conventional and not-so-conventional ideas that offer opportunities for income investors.

James Gruber

Also in this week's edition...

How much you do need to retire? It's an oft-asked question that receives different answers depending who you speak to. **Brendan Coates** and **Joey Moloney** suggest that you ignore the lobby groups who persistently warn of people running out of money in retirement. They say most Australians need to save a lot less than you might think — provided they meet an important condition.

It's a pleasure to welcome renowned global market strategist, **Russell Napier**, to *Firstlinks*. Russell is a former colleague of mine who has the ear of many of the world's best fund managers. In an interview, Russell outlines his contrarian view that investors need to worry about imminent deflation rather than inflation. If right, he says that will result in accelerated Government efforts to upend the monetary system to one of 'national capitalism', where Governments tell investors how and where to invest their capital. And he goes through which assets to own and avoid in this scenario.

On Christmas Eve, the Department of Finance quietly released an improved budget outcome for the first five months of the 2025 financial year. It was markedly different to the more pessimistic outlook that Treasury gave just a week before that. **Clime's John Abernethy** says it highlights how consistently our Government departments get their budget forecasts wrong, impacting RBA decision making and market pricing. He says it's a problem that warrants greater scrutiny.

Bitcoin divides investors like few other assets. Yet, despite being around for 16 years, it's surprising how many investors don't understand what bitcoin is and what it does. **VanEck's Russel Chesler** offers a helpful guide on the ins and outs of bitcoin.

Munro's Qiao Ma is bullish on global small and mid-cap stocks. She highlights three US-based companies that offer compelling upside.

Lawrence Lam has studied and worked with some exceptional companies and leaders, and he shares the secret ingredients behind their successes.

Lastly, in this week's whitepaper, **Capital Group** offers insights into how key market forces - a buoyant US economy, significant opportunities in artificial intelligence, and the renewed appeal of fixed income - are likely to shape portfolios in the year ahead.

Curated by James Gruber, Joseph Taylor, and Leisa Bell

The challenges with building a dividend portfolio

James Gruber

For those seeking regular income, it's tougher going in today's markets. In Australia, the ASX 200's current dividend yield of 3.5% is near its lowest in 25 years. Worse, the dividends aren't expected to grow much over the next 12 months as earnings flatline.

Overseas, it's no better. The S&P 500 is yielding just 1.25%. At least, the US has stronger forecast earnings growth of 15% for 2025, some of which should flow through to dividends.

Given this, where can investors go to find regular income in stocks?

A dividends primer

Many people don't understand where dividends come from and how they grow, so here's a brief guide to get you up to speed. Put simply, dividends come from earnings. So, firstly, you want to own a company that earns a profit. Second, you ideally want a business that is growing its earnings over time. Third, you also hope that the stock will pay out dividends from the growing earnings stream.

Let's look at the example of theoretical company, XYZ:

Year	Equity	Return on equity	Profit	Dividend	Retained
1	100.0	14%	14.0	7.0	7.0
2	107.0	14%	15.0	7.5	7.5
3	114.5	14%	16.0	8.0	8.0
4	122.5	14%	17.2	8.6	8.6
5	131.1	14%	18.4	9.2	9.2

Source: Firstlinks

XYZ has shareholders' equity of $100, from which it makes $14 in profit in year one. Of that profit, it pays out $7 in dividends, equivalent to a dividend payout ratio of 50%. It retains the remaining $7 to fund future growth or improve operations by paying down debt or building a cash reserve for a rainy day.

The company maintains a healthy return on equity of 14% in future years as well as a dividend payout ratio of 50%.

By year five, it's a pretty picture. Equity and earnings have grown nicely, as have dividends. The dividends have increased each year, and amount to $9.20 by year five, compared to $7 at the end of year one.

If I was an income investor in XYZ, I'd be happy.

The ASX's dividend problem

The current issue with Australian shares is that unlike XYZ, they're barely growing earnings, and they're paying out less of those earnings out as dividends. Last financial year, the dividend payout ratio for the ASX 200 fell to 53%.

The market is also putting a heftier price on those earnings and dividends. The current price-to-earnings (P/E) ratio for the ASX 200 is 21.6x, more than 20% above its long-term average.

That's resulted in the dividend yield for Australian stocks falling to 3.5%, almost two standard deviations below its average since 2000. Put another way, the dividend yield has only been lower about 5% of the time over the past 25 years.

The other problem is that growing dividends may prove more challenging going forward. Bank earnings aren't expected to grow much more than mid-single digits over the next 12 months after falling in recent years.

The other index heavyweights, mining companies, are dealing with falling iron ore prices, and both BHP (ASX:BHP) and Rio Tinto (ASX:RIO) are highly leveraged too. That means there is likely to be more dividend cuts from resource firms in 2025.

Where, then, can investors go to find income? Here are some ideas.

Idea 1: High yield dividend ETFs

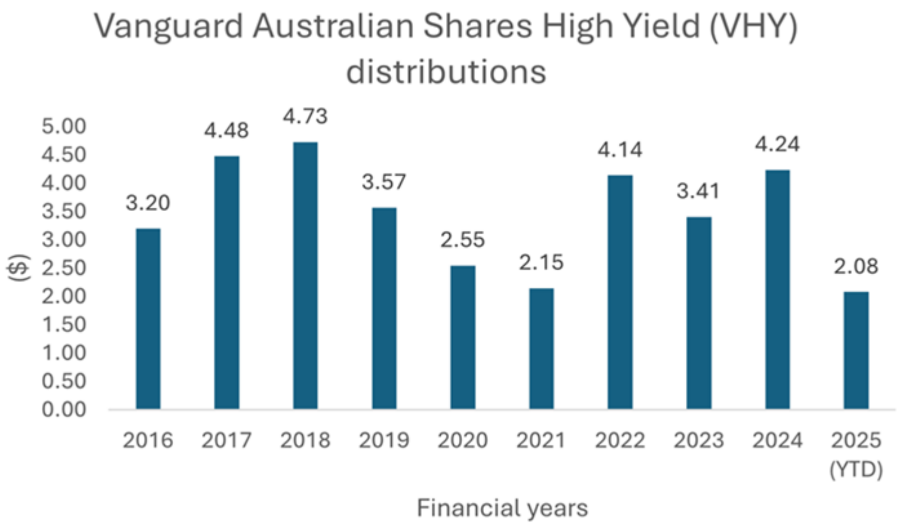
An obvious idea is to own high dividend yielding ETFs. For instance, the largest dividend ETF, Vanguard Australian Shares High Yield (ASX:VHY), sports a forecast dividend yield of 4.8%, which equates to 6.4% grossed up. That compares to the ASX 200 dividend yield of 3.5%.

VHY tracks the return of the FTSE Australia High Dividend Yield Index and invests in companies with higher forecast dividends versus the average ASX company. It pays quarterly distributions, though the dividends aren't fully franked. Franking was 66% in 2024 and 97% in the prior year.

The are a couple of issues with VHY to be aware of. First, it's even more heavily weighted in financials and commodities than the ASX 200. Almost 75% of the ETF is exposed to these two sectors. That means future dividend streams are likely to be volatile - they may go up and down.

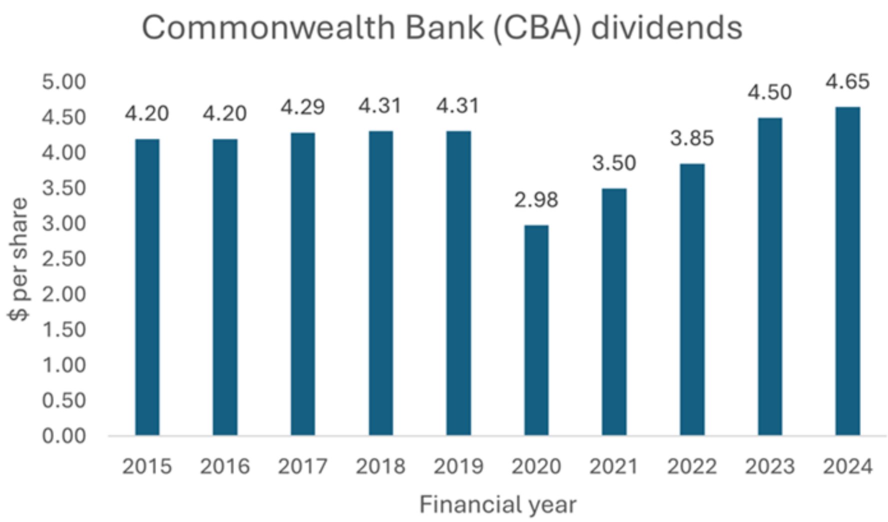
Second, like most high yield ETFs, VHY invests in high dividend yielding companies, and largely neglects those businesses that can grow dividends over time.

Both these issues can be gleaned from the chart below.



Source: Vanguard, Firstlinks

The chart shows VHY dividends by year. As you can see, dividends have bounced up and down. Part of that can be attributed to Covid, though not all of it. Note also how the dividends haven't grown a lot over the past decade. That's what happens when you heavily invest in banks such as CBA, which have struggled to grow earnings and dividends.



Source: CBA, Firstlinks

Despite these drawbacks, VHY or other equivalent ETFs are still worth considering for those seeking regular income. After all, grossed up yields of 6.4% for VHY remain relatively attractive.

Idea 2: Stocks with rising earnings and dividends

The next idea is to invest in Australian shares which are expected to grow profits and dividends. How do you do this? Well, you probably need to look outside of the banks and miners.

One possible option is listed investment company, Whitefield (ASX:WHF), which invests solely in industrials – essentially the ASX 200 minus commodity companies - and has a long track record.

You can also get exposure to faster growing stocks by investing outside the largest companies by market capitalization. For example, Betashares Australian ex-20 Portfolio Diversifier ETF (ASX:EX20) owns just businesses outside the top 20 of the ASX 200. There are also well-run managed funds, such as Auscap's ex-20 Australian Equities Fund, that can achieve similar things.

Another idea is to invest in an equal index weighted ETF. For example, VanEck's Australian Equal Weight ETF (ASX:MVW) offers exposure to the largest ASX companies, but weighted equally rather than by market cap. This results in holding less of the banks and miners, and more of the rest of the ASX.

Of course, you don't have to invest in ETFs and can own stocks directly instead. I won't go into too much detail here as I've outlined many dividend stocks in previous articles, but companies with decent, growing yields on reasonable valuations that I currently like including Telstra (ASX:TLS), Medibank (ASX:MPL), Aurizon (ASX:AZJ), Charter Hall Retail (ASX:CQR), Lottery Corp (ASX:TLC) - all sporting dividend yields from 3.3% to 7.6%.

Idea 3: International stocks

Those seeking income can also invest overseas. Unlike Australia, the US has so-called dividend aristocrats – companies that have not only paid dividends but grown them in each year for at least 25 years. The ProShares S&P 500 Dividend Aristocrats ETF (BATS:NOBL) tracks these companies. The downside is that the current dividend yield for this ETF is just 2.25%. And its total return of 11% over the past decade has trailed the S&P 500's 13.4% (which isn't a big negative given the outperformance of tech companies over everything else).

Another way to invest internationally for income is to just own the S&P 500 index or world index itself. For example, the top 500 companies in the US have grown dividends by almost 8% per annum over the past decade. Of course, past performance is no indicator to the future, though American companies have historically grown earnings by 5% per year in real terms.

Another idea is to get income via thematic investing. I like infrastructure as a theme as many of the companies in the sector - airports, utilities, railroads, toll roads and the like - have critical assets with CPI-adjusted pricing. There are Australian-based global ETFs that capture this theme, including Vanguard's (ASX:VBLD) and VanEck's (ASX:IFRA). There are also managed infrastructure funds with decent track records such as First Sentier, Resolution Capital, and Magellan.

It's worth noting that international investing has some complications that Australian-based investing doesn't. One is tax - dividends here offer franking credits, while those overseas don't. The tax paperwork for overseas dividend paying stocks can also be exhaustive. A further issue is exchange rate fluctuations. Whether to hedge the currency or not is a key decision when investing overseas.

Final considerations

Hopefully this gives you some ideas for getting regular income from stocks. How you build your dividend portfolio will depend on your personal circumstances, so get advice if you need it.

Full disclosure: some of the funds and ETFs mentioned in this article are Firstlinks' sponsors, including Magellan, Resolution Capital, First Sentier, Vanguard, and VanEck.

James Gruber is Editor of Firstlinks.

How much do you need to retire?

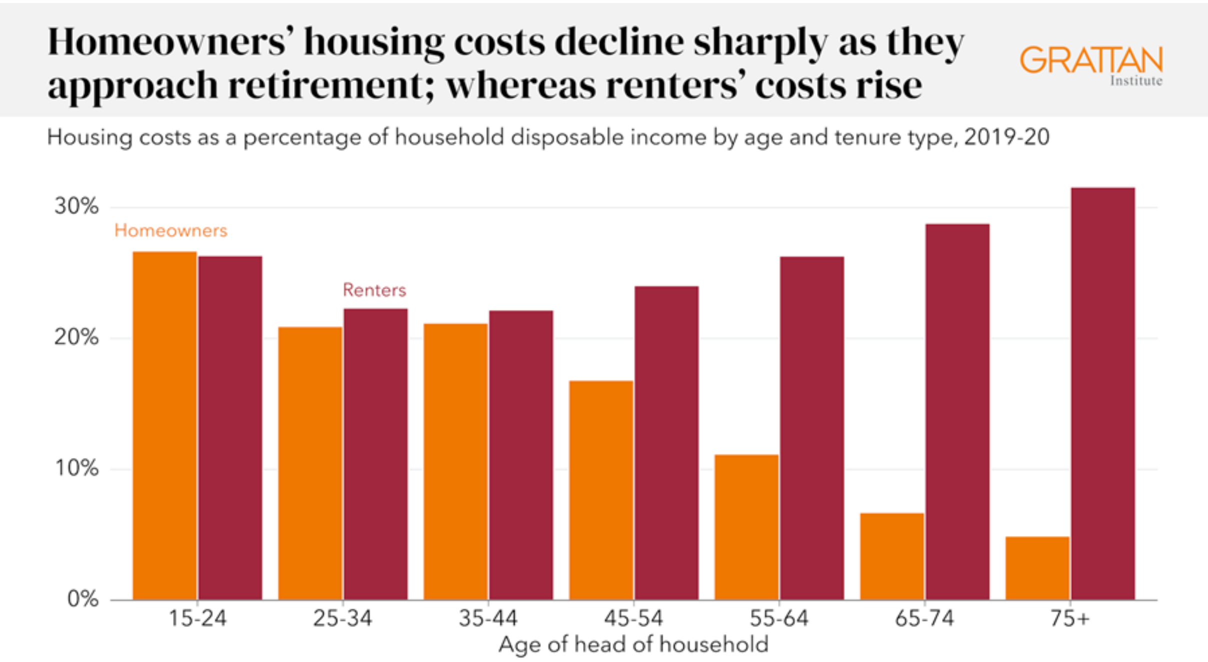
Brendan Coates, Joey Moloney

How much do you need to save for a comfortable retirement? It's a big question, and you'll often hear dire warnings you don't have enough. But for most Australians, it's a lot less than you might think.

You spend less in retirement

Australians tend to overestimate how much they need in retirement. Retirees don't have work-related expenses and have more time to do things for themselves. And retirees, especially pensioners, benefit from discounts on council rates, electricity, medicines, and other benefits worth thousands of dollars a year.

While housing is becoming less affordable, most retirees own their own home and have paid it off by the time they retire. Australians who own their home spend an average of 20–25% of their income on housing while working, largely to pay the mortgage. But that falls to just 5% among retiree homeowners, because they are just left with smaller things such as rates and insurance.



Notes: Housing costs include mortgage interest and principal repayments and general rates for homeowners, and rental payments for renters. Does not include imputed rent. Grattan analysis of ABS (2022) Survey of Income and Housing.

And whatever the income you need at the start of your retirement, it typically falls as you age. Retirees tend to spend 15–20% less at age 90 than they do at age 70, after adjusting for inflation, as their health deteriorates and their discretionary spending falls. Most of their health and aged-care costs are covered by government.

So how much superannuation do you need?

Consumer group Super Consumers Australia has crunched the numbers on retiree spending and presents three robust "budget standards":

- a "low" standard (that is, enough for a person who wants to spend more than what 30% of retirees do)
- a "medium" standard (spending more than 50% of retirees do), and
- a "high" standard (more than 70%).

How much super do you need?

GRATTAN Institute

Super Consumers Australia retirement savings targets, $2023

		Pre-retirees (aged 55-59)		Retirees (65-69)	
		Target spending per year	Target balance by age 65	Target spending per year	Target balance by age 65
Single	Low	$36,000	$91,000	$31,000	$76,000
	Medium	$47,000	$317,000	$41,000	$279,000
	High	$59,000	$777,000	$55,000	$759,000
Couple	Low	$52,000	$116,000	$44,000	$95,000
	Medium	$69,000	$425,000	$60,000	$371,000
	High	$87,000	$1,037,000	$80,000	$1,055,000

Super Consumers Australia (2023) Retirement Savings Targets

Crucially, these estimates account for the significant role of the Age Pension in the retirement income of many Australians. The maximum Age Pension is now $30,000 a year for singles, and $45,000 a year for couples.

To meet Super Consumers Australia's "medium" retirement standard, a single homeowner needs to have saved only $279,000 in super by age 65 to be able to spend $41,000 a year. A couple needs only $371,000 in super between them to spend $60,000 a year.

To meet their "low" standard – which still enables you to spend more than 30% of retirees – single Australians need $76,000 in super at retirement, and couples $95,000 (while also qualifying for a full Age Pension of $30,000 a year).

That's provided that you own your own home (more on that later).

Ignore the super lobby's estimates

Australians should ignore the retirement standards produced by super lobby group, the Association of Superannuation Funds of Australia. Their "comfortable" standard assumes retirees need an annual income of $52,085 as a single, and $73,337 as a couple. This would require a super balance of $595,000 for a single person, and $690,000 for a couple.

But this is a standard of living most Australians don't have before retirement. It is higher than what 80% of single working Australians, and 70% of couples, spend today.

For most Australians, saving enough to meet the super lobby's "comfortable" standard in retirement can only come by being uncomfortable during their working life.

Most Australians are on track for a comfortable retirement

The good news is most Australians are on track. The Federal Government's 2020 Retirement Income Review concludes most future Australian retirees can expect an adequate retirement, replacing a more-than-reasonable share of their pre-retirement earnings – more than the 65–75% benchmark nominated by the review.

Even most Australians who work part-time or have broken work histories will hit this benchmark.

Most retirees today feel more comfortable financially than younger Australians. And typically, they have enough money to sustain the same, or a higher, living standard in retirement than they had when working.

Rising mortgage debt doesn't change this story

More Australians are retiring with mortgage debt – about 13% of over-65s had a mortgage in 2019–20, up from 4% in 2002–03. But the Government's retirement income review found most retirees who used $100,000 of their super to pay off the mortgage when they retire would still have an adequate retirement income.

This is, in part, because many would qualify for more Age Pension after using a big chunk of super to pay off the mortgage.

And retirees can get a loan via the government's Home Equity Access Scheme to draw equity out of their home up to a maximum value of 150% of the Age Pension, or $45,000 a year, irrespective of how much Age Pension you are eligible for.

The outstanding debt accrues with interest, which the government recovers when the property is sold, or from the borrower's estate when they die, reducing the size of the inheritance that goes to the kids.

But what about renters?

One group of Australians is not on track for a comfortable retirement: those who don't own a home and must keep paying rent in retirement.

Nearly half of retired renters live in poverty today.

Most Australians approaching retirement own their own homes today, but fewer will do so in future. Among the poorest 40% of 45–54-year-olds, just 53% own their home today, down from 71% four decades ago.

But a single retiree renting a unit for $330 a week – cheaper than 80% of the one-bedroom units across all capital cities – would need an extra $200,000 in super, in addition to Commonwealth Rent Assistance (according to the government's Money Smart Retirement Planner).

This is why raising Commonwealth Rent Assistance to help renting retirees keep a roof over their heads should be an urgent priority for the Federal Government.

Australians have been told for decades that they're not saving enough for retirement. But the vast majority of retirees today and in future are likely to be financially comfortable.

This article is part of The Conversation's retirement series, in which experts examine issues including how much money we need to retire, retiring with debt, the psychological impact of retiring and the benefits of getting financial advice. Read the rest of the series here.

Brendan Coates, Program Director, Housing and Economic Security, Grattan Institute and Joey Moloney, Deputy Program Director, Housing and Economic Security, Grattan Institute

Why a deflationary shock is near

Russell Napier, Mark Dittli

Russell Napier is a renowned global market strategist, formerly with Hong Kong brokerage, CLSA, and author of Anatomy of The Bear. This is an interview he did with The Market NZZ's Mark Dittli late last year.

Mark Dittli: When we last spoke, you said that governments had found the magic money tree: That by guaranteeing bank loans, they could create money at will, paving the way to financial repression and inflating away their debt. Is that still your view?

Russell Napier: In the long term, yes. Financial repression and inflating away bloated debt levels will be with us for years, even decades. But I think we're experiencing a hiatus first. Governments did exactly what I said in 2021. They created money on a massive scale. Their actions, quite predictably, led to inflation. But then they panicked. So they handed the ball back to the central bankers and said do something about this. In my opinion, central banks have done too much, they hit the brakes too hard. Hence my fear that we might be facing a deflation shock in the short term.

MD: You're saying central banks have tightened too much?

RN: Yes. We've seen a collapse in the growth of broad money in a magnitude that we hadn't seen since the 1930s. Now, you might say this doesn't matter since so much broad money was created between 2020 to 2022, and clearly it hasn't mattered for the past two years. But now it's starting to bite. That's my evidence that they have overtightened.

MD: Both in the US and in Europe, M2 growth has picked up again. Central banks have started cutting rates. Why do you still fear a deflation shock?

RN: You're right, M2 growth has picked up a bit, but it is growing too slowly. It would need to accelerate. The level of M2 growth in relation to the current level of interest rates is just not compatible with what would be needed to sustain economic growth.

MD: Inflation, especially in the US, shows signs of stickiness. Don't you think another inflationary wave might be in the making?

RN: I can't reconcile that with the growth rate of broad money. Sure, if we were to suffer a supply shock, then inflation would go up, regardless of what broad money does. But absent that, if broad money is not going up, it suggests that economic activity is going to weaken. I always look at things through a monetary prism. In my view, the next shock is more likely to be deflationary.

MD: Where could that shock come from?

RN: You and I could hypothesise about that all day. It could be a spike in French bond yields. It could be China floating its exchange rate, which would cause the yuan to devalue. It could be the yen carry trade unraveling again. And there's a fourth possibility, which is the unknown unknown. Somebody somewhere gets into trouble, and we'll see something break in the financial system.

MD: So basically you are saying that we first might experience a deflation shock before we go back to a world of higher inflation?

RN: Yes, my longer-term view of financial repression remains unchanged. That's the only way I see that will lead us out of the record high levels of debt. Mind you, I use the term deflation shock, but I'm not sure we'll see outright deflation. Deflation shocks are bad for the economy, they are ugly for equities, and they are very dangerous for high levels of debt. You don't make money as an investor by trying to predict deflation shocks, you make money by anticipating the government reaction to deflation shocks. And I am convinced that governments will react swiftly by forcing banks to lend, by suppressing interest rates and by using national savings to invest in things they want.

MD: What are the signs that tell you this is happening?

RN: On April 26th, President Emmanuel Macron of France held a speech at the Sorbonne, titled Europe – It Can Die. Read it. It's a sea change. In a telling bit of his speech, Macron says that every year, Europeans send 300 billion euros to the US to fund the American government and American corporations. In other words, he's outlining a concept of national savings, and they should be used for the national good. Mario Draghi in his report to the EU Commission also outlines all the things that should be done with new money. The British, meanwhile, are talking about mandation, which posits that pension funds in Britain must invest a certain percentage of their funds domestically. That's what lies ahead. Governments will tell investors how and where to invest their capital.

MD: And that would conform to your definition of financial repression?

RN: Yes. I say we are headed towards a system of national capitalism. Interestingly, the term national capitalism has been used before, by a man who used to live in Zurich for a while: his name was Lenin. In a system of national capitalism, governments direct national savings towards national purposes. And our purposes today are investments, as outlined by Macron or Draghi and also by industrial policy initiatives in the US: Investments in energy infrastructure, in defense, in new productive capacity in order to de-risk from China. If we get into a bad Cold War with China, this will have a high national priority.

MD: Do you expect a continuation of the boom in capital expenditures that you outlined two years ago?

RN: Yes, everything is aligning. You may call it industrial policy, friendshoring, or de-risking. It adds up to the same thing: state-directed investment. Again, read the Macron speech. He says if we don't learn to build stuff again, Europe can die. Of course, he's prone to overdramatic statements, but he didn't say Europe is a bit ill. He said Europe can die. This is a question of life and death. Building military equipment is life and death stuff. It has become an issue of national survival to invest. Governments all over the world find the need to direct investments to purposes they want to achieve.

MD: And because debt levels already are at record highs and markets don't provide financing at acceptable rates, national savings will have to be tapped and interest rates will have to be suppressed?

RN: Exactly. Globally, total debt to GDP today is close to 200%. We've never seen that before. France is at 311%, the US at 255%, Japan at 400%. We are talking about at least a decade and a half to get this under control. For Japan and France it will take even longer.

MD: Do you see the possibility that technology, such as AI, will create a productivity boom, lifting real economic growth, which would help our economies to grow out of their debt?

RN: There are only five ways out of a debt problem: Austerity, default, high real growth, hyperinflation or financial repression. The best one for all of us would be high real growth. To have that, you need a productivity revolution, we'd need to lift real growth to 3 or 4% per annum. Will AI deliver that? I doubt it. Look at the internet revolution: It has transformed the entire world, but it didn't boost productivity much. There's an interesting book by my friend Alasdair Nairn, titled Engines that Move Markets. He goes back to the railway boom in the 19th century, and he shows a very consistent pattern: When a new technology appears, it attracts huge amounts of capital. There is physical investment on a massive scale. This inevitably leads to overinvestment, creating bad returns, and then the whole thing collapses. It's usually in the ruins of the first investment bubble where you can identify the truly productive uses of the new technology. Think of Amazon: Today, it's a clear winner of the internet age. But from 2000 to 2003, its share price fell by 90%. Will AI be different? I'm not smart enough to work that out. But I doubt it.

MD: You mentioned that you see the world moving towards a system of national capitalism. This would upend everything that most investors today take for granted: free flow of capital, market based bond yields, and the like.

RN: Yes. The most important part is the idea that national savings shall be used for national purposes. There will be a big push to repatriate capital, back to Europe and back to Japan, for example. The other part is that we need to understand how much of the current world financial system is based on China and its decision in 1994 to manage its currency against the dollar. After the 1997-98 Asian Financial Crisis, most Asian countries started to do the same thing. The result was an exponential growth in dollar reserves. These were all non-price-sensitive buyers of Treasuries and other US assets. This huge flow of capital has pushed interest rates down and equity prices up. Today, 58.5 trillion dollars worth of American assets are owned by foreigners. Arguably, this system started falling apart in 2014, when global forex reserves peaked. It's now coming to an end, because it's not working for China anymore. China has reached the end of the rope, both in terms of its total debt to GDP and also in terms of the rest of the world not willing to absorb China's overproduction anymore. Historically, every 30 or 40 years monetary systems collapse. The current one, the one we have lived with since 1994, is collapsing in front of our eyes.

MD: What will the new world financial order look like?

RN: Let's deal with China first. China will separate from the rest. They will want to adopt a truly independent monetary policy, a policy that will need to be much looser in order for them to address their domestic economic problems and to inflate away their domestic debt. They would simply say the exchange rate is no longer a target. As a consequence of that, I forecast that their currency will fall. Many observers think China can form a new system with their ‹allies›. But for that to happen, we would need to see the holdings of the renminbi as a reserve asset going up. We get data on that every quarter from the IMF, and it shows that it's not happening. Beijing may be setting up a system where countries can settle trade in renminbi, but so far, all the evidence we have is that nobody wants to hold renminbi as a reserve asset.

MD: Okay, so you think that China will devalue. What about the financial system for the rest of the world?

RN: It has to be a system that permits everybody to inflate away their debt. It has to be a system that allows inflation and a suppression of domestic interest rates through the use of national savings. Which means there will have to be forms of capital controls. In today's world, where most financial assets are held by institutions, capital controls can take the form of regulation. Think of your government regulator mandating all pension funds to buy a certain amount of government debt or other domestic financial assets. That's what national capitalism will look like.

MD: That sounds ghastly.

RN: It won't necessarily feel bad for the whole population – at least for the first several years. Remember, governments want to channel a lot of capital investment into their economies, while slowly inflating away their debt. This system is terrible for savers, but it won't feel so bad for blue collar workers. An active equity investor can benefit from the redistribution of wealth from savers to workers and from the older generation to the younger generation. There will be some corporate winners in the new regime.

MD: As an investor, where should one invest now?

RN: You shouldn't own any fixed interest securities. None. Inflating away debt means destroying the purchasing power of fixed income securities. There may be rallies, but fixed income is in a long bear market. Bond bull and bear markets move in about 40-year periods, and now we are into year three of the current bear market. You can lose a fortune in real terms over the long term. Therefore: No bonds. Period.

MD: What to buy, then?

RN: Gold is up 30% this year already, and I'd still want to own gold. It's the standout asset. I am talking about nothing less than a breakdown of the global monetary system as we've known it since 1994. When the Bretton Woods system broke down in 1971, gold went from $30 to $850 an ounce. All you know is when you get a structural breakdown in the global monetary system, gold will go up. We haven't seen that move yet. I have just spent two weeks talking to fund managers, and I can tell you they are not really into gold yet. And, of course, the largest part of your portfolio should be in equities.

MD: Which equities should one own?

RN: This is rather tricky. Because if we move into a world where every developed world savings institution has to repatriate assets to buy bonds of their own government, they will need to liquidate the one asset they have all crammed into in the past years: the S&P 500. Over the past years, all the world's institutional investors have crowded into large-cap US equities. If they are mandated to own domestic assets, they would be forced to sell US assets. So you would not want to own the S&P 500.

MD: Because that's the asset that will be liquidated?

RN: Yes. And it starts at a historically high valuation. The S&P 500 is excessively overvalued and over-owned by foreigners who may be forced sellers.

MD: What should you own then?

RN: Equities that won't be liquidated, because they are not overly represented in the portfolios of institutional investors. The unloved, under-owned assets: mid and small caps, as well as value stocks. Also, I'd look out for equities that benefit from the global capex boom. Japan offers many of them. The typical fund manager today has 40% in bonds and 60% in equities, of which more than half is in the S&P 500. They're all crowded into the same assets. In order to do well in the big structural change that I see coming, you have to be radical in your portfolio. No bonds, no S&P 500. Buy equities that no one wants today, and own much more gold. Conventional wisdom will declare the quantities you own of these assets risky while accepting that the assets you own are not particularly risky. This is the position that has always rewarded investors when a major structural change has come along.

Russell Napier is author of the Solid Ground Investment Report und co-founder of the investment research portal ERIC. He has written macroeconomic strategy papers for institutional investors since 1995. Russell is founder and director of the Practical History of Financial Markets course at Edinburgh Business School and keeper of the Library of Mistakes, a library of financial markets history in Edinburgh.

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Federal budget forecast errors need greater scrutiny

John Abernethy

There is an old adage in the stock market, that a listed public company will release bad news 'after market' or late on a Friday, or better still, on Christmas Eve. This is based on the reasonable expectation that no one should be watching, and the financial press would have vacated their desks.

This is what makes the announcement by Australia's Department of Finance ("Finance"), on Christmas Eve 2024 - of a significantly improved "actual" budget outcome for the first 5 months of FY25 - most intriguing. The announcement was published on its website and without much fanfare.

The update contrasted with Treasury's benign Mid-Year Budget (MYEFO) that was released by the Treasurer just a week earlier.

The differences were stark and significant for the FY25 budget position as we enter a pre-election period. Indeed, the differences highlighted that Treasury forecasts (on Budget night) have been consistently wrong over the last three years, and by big margins. Indeed, the difference between the budget forecast and the budget outcome have amounted to tens of billions of dollars representing a significant 1% to 2% of GDP. Far too large to dismiss as mere aberrations.

This is concerning because markets and investors rightly consider and then react to budget projections that are reported in both budget forecasts and outcomes. The declared positioning of Government fiscal policy will support or detract from economic growth and the confidence in the outlook for economic growth.

For instance, a 1% fiscal deficit (to GDP) will have growth repercussions that are not as significant as those of a surplus budget. Inflation fears may be stoked or dampened by declared fiscal policy and the difference between budget revenue (tax) and expenses. Interest rate guidance and the cash settings of the RBA will be adjusted and based on fiscal outcomes that support or detract from economic activity.

What did Treasury and Finance state and how were they different?

In its mid-year update Treasury forecast only a slightly improved deficit for FY25 of $26 billion (down from the May budget forecast of $28 billion). It also forecast that the budget would be unlikely to reach an annual surplus inside a decade and noting (see below) that the trajectory of the budget would further deteriorate over the next three fiscal years.

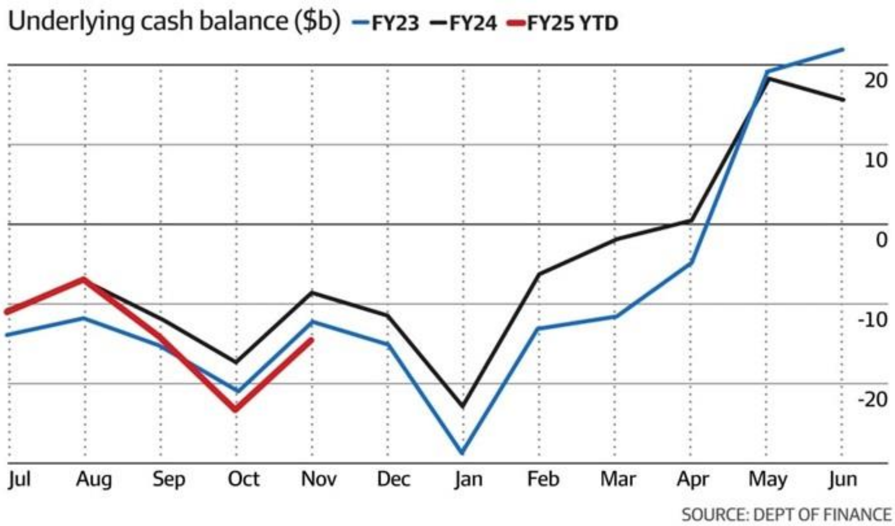
Table 1.2: Budget aggregates

	Estimates							
	2024–25		2025–26		2026–27		2027–28	
	$b	% GDP	$b	% GDP	$b	% GDP	$b	% GDP
Underlying cash balance								
MYEFO	-26.9	-1.0	-46.9	-1.6	-38.4	-1.3	-31.7	-1.0
Budget	*-28.3*	*-1.0*	*-42.8*	*-1.5*	*-26.7*	*-0.9*	*-24.3*	*-0.8*
Gross debt(a)								
MYEFO	940.0	34.0	1,028.0	36.0	1,100.0	36.7	1,161.0	36.7
Budget	*934.0*	*33.9*	*1,007.0*	*35.1*	*1,064.0*	*35.2*	*1,112.0*	*34.9*
Net debt(b)								
MYEFO	540.0	19.6	609.3	21.3	669.2	22.3	708.6	22.4
Budget	*552.5*	*20.0*	*615.5*	*21.5*	*660.0*	*21.8*	*697.5*	*21.9*

a) Gross debt measures the face value of Australian Government Securities (AGS) on issue.
b) Net debt is the sum of interest bearing liabilities (which includes AGS on issue measured at market value) less the sum of selected financial assets (cash and deposits, advances paid and investments, loans and placements).

Source: Budget 2024-25 Mid-Year Economic and Fiscal Outlook 2024–25

A week later, on Christmas eve, the Finance update showed that the current year deficit for five months to November was just $5 billion and barely different to the positions seen at the same point in FY23 and FY24 which produced budget surpluses of around $20 billion.



As at the end of November the 'net operating cashflow balance' was $14 billion better than forecast in the original budget (May) and the updated forecast in the MYEFO.

AGGREGATES(a)	ACTUAL 2024-2025 November $b	ACTUAL 2024-2025 YTD November $b	BUDGET ESTIMATE* 2024-2025 FULL YEAR $b	MYEFO ESTIMATE^ 2024-2025 FULL YEAR $b
Receipts(b)	**66.3**	**280.5**	**698.4**	**704.2**
Payments(c)	**57.3**	**294.5**	**726.7**	**731.1**
Underlying cash balance	**9.0**	**-14.0**	**-28.3**	**-26.9**
Headline cash balance	**8.5**	**-15.8**	**-47.2**	**-47.8**
Revenue	67.2	288.2	711.5	718.3
Expenses	57.1	293.7	734.5	758.6
Net operating balance	**10.2**	**-5.5**	**-23.0**	**-40.4**
Net capital investment	0.6	-0.4	6.3	5.5
Fiscal balance	**9.5**	**-5.1**	**-29.3**	**-45.9**
Total assets		**858.9**	**837.6**	**851.5**
Total liabilities		**1,399.0**	**1,382.7**	**1,422.1**
Net worth(d)		**-540.1**	**-545.1**	**-570.6**
Net debt(e)		**514.5**	**552.5**	**540.0**

*As published in the 2024-25 Budget.
^ As published in the 2024-25 Mid-Year Economic and Fiscal Outlook.
(a) Discrepancies in tables between totals and sums of components are due to rounding.
(b) Cash receipts for operating activities and sales of non-financial assets.
(c) Cash payments for operating activities, purchases of non-financial assets and principal payments of lease liabilities.
(d) Net worth is calculated as total assets minus total liabilities.
(e) Net debt is the sum of interest bearing liabilities less the sum of selected financial assets (cash and deposits, advances paid, and investments, loans and placements).

Source: Australian Government General Government Sector Monthly Financial Statements for November 2024

The improvements are seen below in the Finance report of December 2024. Year to date:

- Total receipts were $11 billion better than expected.
- Taxation receipts (mainly PAYG) were $8.4 billion than expected; and
- Expenses were $2.3 billion than expected.

	ACTUAL 2024-2025 November $m	ACTUAL 2024-2025 YTD November $m	Budget Profile 2024-2025 YTD November $m	BUDGET ESTIMATE* 2024-2025 FULL YEAR $m
Cash receipts from operating activities				
Taxes received	64,055	253,105	244,707	642,542
Receipts from sales of goods and services	699	10,913	9,728	21,396
Interest receipts	922	4,934	4,499	9,275
Dividends, distributions and income tax equivalents^	-581	3,134	2,720	6,789
Other receipts	1,149	8,203	7,047	18,231
Total operating receipts	**66,243**	**280,290**	**268,701**	**698,233**
Cash payments for operating activities				
Payments for employees(b)	-3,618	-19,653	-19,712	-46,840
Payments for goods and services	-16,665	-86,727	-86,373	-210,763
Grants and subsidies paid	-16,839	-95,067	-99,496	-251,111
Interest paid	-4,589	-8,760	-9,389	-23,824
Personal benefit payments	-13,006	-70,158	-68,916	-161,714
Other payments(b)	-888	-5,174	-3,995	-10,389
Total operating payments	**-55,606**	**-285,538**	**-287,882**	**-704,641**
Net cash flows from operating activities	**10,638**	**-5,249**	**-19,181**	**-6,408**

Source: Australian Government General Government Sector Monthly Financial Statements for November 2024

In summary, tax collections make up the bulk of the difference with an extraordinary $8 billion (above forecast) drawn from individual income tax payments – and that is after the tax scale adjustments of 1 July. Company taxation collections are $0.5 billion better than forecast. Notable was that the budget forecast was for company taxation collections to fall.

Therefore, what does it suggest that Treasury has wrongly forecast?

1. **Higher actual employment numbers** i.e. more people are working and therefore paying PAYG. Remember the unemployment rate may rise but more people can be working. The latest employment release showed that 56,000 jobs were added to the economy in December 2024 whist the unemployment rate ticked up. Australia's employment participation rate has never been higher. Clearly immigrants like to work!

2. **A lower AUD that holds export revenue**. Treasury, like many other forecasters, do not acknowledge that the surging inflows into superannuation are driving super capital investment flows to offshore markets and weakening the AUD more so than the surging USD; and

3. **The maintenance of higher iron ore export prices** which remain 50% higher than budget forecasts – a feature common in budget forecasts for at least the last five years.

I draw some conclusions from the above which will be contested by many:

1. The tax cuts for low-income workers from 1 July should have been larger and they should have been set with an agreement for lower wage claims across the Government sector (Commonwealth and State). The elevated wage claims flowing across the economy, notably in the state government sector, are symptomatic of a poorly structured and un-coordinated wages income tax policy.
2. Electricity rebates should have been greater than $300, and this would have driven reported inflation lower. So too would have been a reduction in petrol excises. The indexing of petrol excises without a review mechanism, after inflation has surged, is a nonsensical policy given it further adds to both the cost of living and the cost of doing business. Most current Government sector wage claims are focused on the recovery of the cost-of-living increases.
3. There is now capacity for the Government to offer pre-election and vote buying gifts that will not upset the original forecast budget estimate ($28 billion deficit). For instance, we should expect the extension of energy rebates amongst other short-term giveaways. The Opposition can join the giveaways if it can understand what has changed in the budget outcome; and
4. Alternatively, the FY25 budget outcome (if untouched by the Government) will be significantly better than forecast and could even approach a surplus. The Government can claim that it is a superior financial manager – but unfortunately (for them) the budget outcome will be seen after the election votes are counted.

Federal budgets have always been political documents but the discrepancies that are appearing between Treasury forecasts and actual outcomes needs greater scrutiny. This suggests that the claims of each political party, that they have better fiscal management discipline, will need to be treated with extreme scepticism in the forthcoming election.

Neither party seems capable of explaining the drivers of budget outcomes and the budget adjustment opportunity to the Australian population. Neither party have declared plans to adjust fiscal policy to check the cost of living inside a coordinated plan to lift real wage outcomes (after tax).

A proper review of the illogical (in many respects) taxation laws of Australia remains stalled leading to excessive taxation payments by workers.

The immense growth opportunity of Australia remains untapped as politicians argue inanely with each other.

John Abernethy is Founder and Chairman of Clime Investment Management Limited, a sponsor of Firstlinks. The information contained in this article is of a general nature only. The author has not taken into account the goals, objectives, or personal circumstances of any person (and is current as at the date of publishing).

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A reluctant investor's guide to understanding bitcoin

Russel Chesler

Among the list of sweeping changes Trump has promised as President of the United States are specific initiatives that support bitcoin, including retaining bitcoin as a government-held reserve. Accordingly, the price of bitcoin has been breaking records, and surpassed the US$100,000 mark. Regardless of your previous thoughts on bitcoin, it's worth understanding the basics, as it is clearly here to stay.

Many investors have, understandably, given bitcoin a wide berth, with its price ascension, volatility and lack of intrinsic value conjuring allusions to tulip mania and other speculative bubbles. However, the SEC ruling in the US earlier last year provided a crucial turning point for the cryptocurrency, establishing bitcoin as a legitimate asset and paving the way for a flurry of bitcoin ETFs in the US and locally on the ASX.

We could now be at the dawn of another pivotal moment for bitcoin, along with the broader asset class known as digital assets, with the Trump presidency.

How did we get here?

Currencies have undergone a number of evolutions in the last 100 years. It wasn't all that long ago that the world relied on physical gold - up until the 1940s, countries tied the value of their currency to the amount of gold they physically held. And it was only in the 1970s that the world moved to floating currencies, whereby value was determined by supply and demand. Following the creation of the euro zone, we saw the first region-based rather than country-based currency. And now we have global currencies via cryptocurrencies.

The digitisation of the world has completely transformed almost every aspect of our lives, so it should be no surprise that currencies and money are also being transformed.

Cryptocurrencies are digital currencies and can be used to pay for goods and services, just like we do with paper-based money, and as a store of value, like gold. A unit of cryptocurrency is known as a 'token' or 'coin', and these are stored in an online 'wallet'. In the same way we use specific exchanges for trading shares and ETFs, like the ASX and the NYSE, you can buy and sell units of various cryptocurrencies via specific online exchanges.

An important differentiator of cryptocurrencies is that they are 'decentralised', meaning they operate independently of any government or bank. Traditional currencies are managed by a country or region's central bank, which influences its value via changes in interest rates, and supply controls via monetary policy. Cryptocurrency prices are not beholden to such influences.

Relying on an encrypted peer-to-peer system of exchange, cryptocurrency is derived from the word cryptography - the process of coding information so only the person intended to receive said information can decipher it. However, while we've come a very long way since The Enigma Code, investors should be mindful of the risk of crypto wallets and exchanges being raided and assets stolen. According to reports, hackers stole in excess of US$2 billion in cryptocurrency in 2024.

Bitcoin 101

Bitcoin is the most established and accepted cryptocurrency. It has become a significant currency both on- and offline and currently has a market capitalisation in excess of US$1.8 trillion[1], which is higher than Berkshire Hathaway and Tesla[2].

Now, more than ever, merchants and businesses are accepting bitcoin as a form of payment and infrastructure has been built to make it more convenient for the average person to use. Users can now buy and pay for items using bitcoin wherever PayPal is accepted. The development of user-friendly wallets, exchanges, and marketplaces has removed the technical barriers to entry that existed in bitcoin's early years.

Since inception in 2009, bitcoin's increase in value has been extraordinary. From trading below the US$500 mark in its early years, its current value hovers around US$106,000. Bitcoin's historical performance can be characterised as extremely volatile yet upward trending.

Like gold, bitcoins are produced via 'mining'. Only, instead of using specialised mining equipment such as drills, explosives, longwalls and excavators, bitcoin miners use hyper sophisticated computers to compete to solve complex mathematical problems. Bitcoins are the reward.

There will only ever be 21 million bitcoins in existence. This supply cap was designed intentionally and is one of the primary characteristics of bitcoin.

Furthermore, bitcoin has 'halvings' programmed into it. At each halving, bitcoin miners will earn half as many bitcoins as they did prior to the halving event. Halvings occur roughly every four years and result in a slowdown in the rate at which new bitcoins are introduced into circulation over time until it eventually reaches zero (estimated to occur around the year 2140). The last halving occurred on 20 April 2024. Historically, the price of bitcoin has rallied leading up to and following a halving.

While increasing scarcity can lead to increased value, investors have also been attracted to bitcoin as a portfolio diversifier. Bitcoin has a low correlation to traditional asset classes.

Chart 1: Since 2013, bitcoin's price has experienced dramatic highs and lows

Source: VanEck, Morningstar as at 31 October 2024. Representing the price of bitcoin is the MarketVector™ Bitcoin Benchmark Rate. Past performance is not indicative of future performance.

Chart 2: Bitcoin's correlation to traditional asset classes

Asset class	Bitcoin	Australian bonds	Global bonds	Cash	EM equities	NASDAQ 100	Global equities	A-REITs	Australian equities	Gold
Bitcoin	1.00									
Australian bonds	0.09	1.00								
Global bonds	0.18	0.81	1.00							
Cash	0.00	0.19	0.18	1.00						
EM equities	0.11	0.22	0.30	0.10	1.00					
NASDAQ 100	0.27	0.38	0.35	0.12	0.39	1.00				
Global equities	0.30	0.34	0.31	0.13	0.46	0.86	1.00			
A-REITs	0.25	0.43	0.56	0.07	0.38	0.45	0.63	1.00		
Australian equities	0.29	0.26	0.38	0.03	0.47	0.51	0.68	0.83	1.00	
Gold	-0.01	0.30	0.18	0.14	-0.02	-0.10	-0.15	-0.10	-0.28	1.00

Source: Morningstar Direct, Ten-year correlation, 31 October 2024. Indices used: Australian Bonds is Bloomberg AusBond Composite 0+Y Index, Global bonds is Bloomberg Global Aggregate TR Hdg AUD Index, Bitcoin is MarketVector Bitcoin PR Index, Cash is AusBond Bank Bills Index, EM equities is MSCI Emerging Markets Index, Global equities is MSCI World ex Australia Index, A-REITs is S&P/ASX 200 A-REIT Index, Australian equities is S&P/ASX 200 Index, Gold is LBMA Gold Price PM.

Bitcoin as a mainstream asset class

The approval of bitcoin ETFs by the SEC and ASX has enabled the wealth management community and individuals to access bitcoin via a regulated and insured investment vehicle, opening up the asset class to institutional investors including hedge funds, sovereign wealth funds, pension funds, and registered investment advisors. The Trump administration plans to further solidify the cryptocurrency as a mainstream asset.

Trump was the first Presidential candidate to brand himself 'pro-crypto'. Among his pledges were:

- A strategic national crypto stockpile;
- A change in direction, in terms of approach to regulation and from the aggressive stance taken under the previous administration;
- Ensure the US is the global centre of bitcoin mining; and
- Fed rate cuts, which have historically boded well for bitcoin.

According to our latest Australian Investor Survey, more than 1 in 10 respondents are considering investing in a bitcoin ETF in the next 12 months. Meanwhile 95% of Australian financial advisers would consider allocating to a bitcoin ETF, according to the 2024 VanEck Smart Beta Survey.

Sources:
[1]Coindesk, as at 19 November 2024
[2]Bloomberg, as at 19 November 2024

The VanEck Bitcoin ETF (ASX: VBTC) offers investors exposure to the price of bitcoin while providing institutional-grade protection of the bitcoin investment.

Key risks: *An investment in VBTC involves extremely high risk and the potential for loss of all capital invested. Investors should actively monitor their investment as frequently as daily to ensure it continues to meet their investment objectives. Risks associated with an investment in VBTC include those associated with pricing risk, regulatory risk, custody risk, immutability risk, ASX trading time risk, concentration risk, environmental risk, currency risk, operational risk, underlying fund risk and forking risk. See the VanEck Bitcoin ETF PDS and TMD for more details.*

Russel Chesler is Head of Investments and Capital Markets at VanEck, a sponsor of Firstlinks. Russel is responsible for managing VanEck's Australian ETFs. This is general information only and does not take into account any person's financial objectives, situation or needs. Any views expressed are opinions of the author at the time of writing and is not a recommendation to act.

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Unearthing small and mid-cap gems

Qiao Ma

Heading into 2025, some of the most exciting opportunities that we find are in the often-overlooked small and mid-cap space.

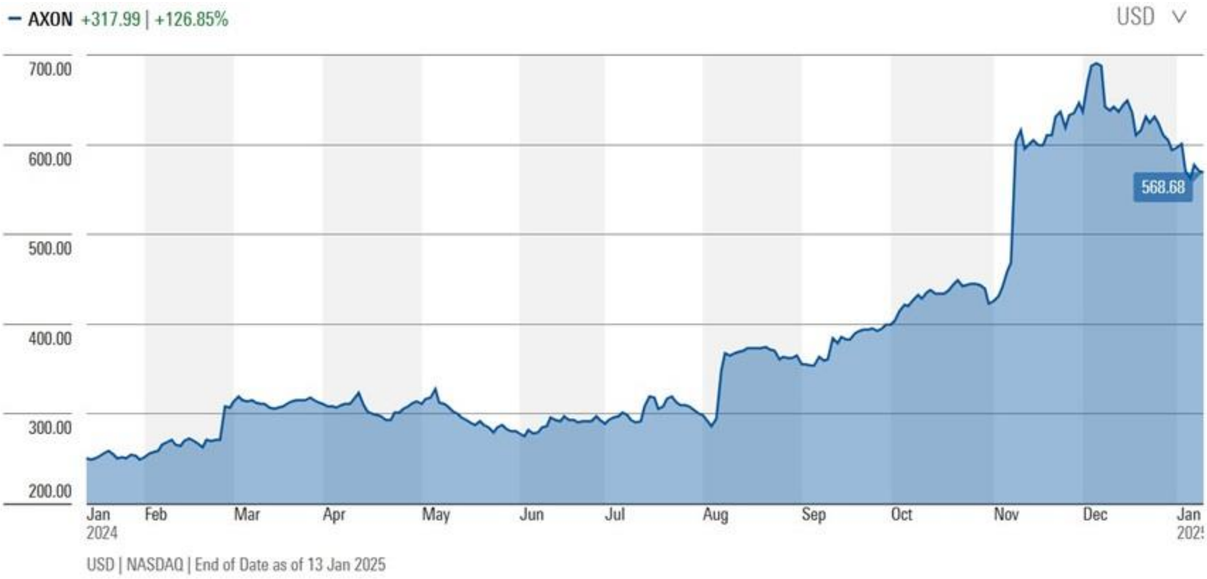
Small boats, big sails

As growth investors at Munro Partners, we seek companies that demonstrate sustainable earnings growth over the long run. We are finding compelling opportunities in companies that are small in size today but are positioned to benefit from massive long-term structural growth trends.

We identify these trends as 'Areas of Interest' (AOI) – trends that we think represent enduring tailwinds that will shape the global economy for decades to come. Some AOI themes include Security, Climate, High-Performance Computing, and Digital Media & Content.

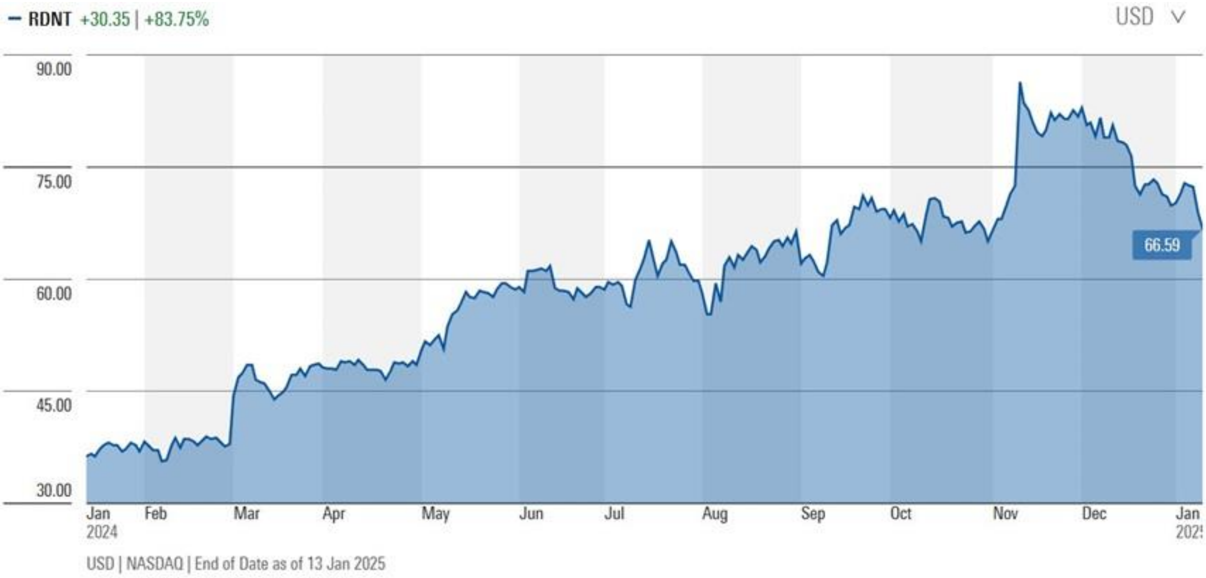
The small companies that are strategically aligned with these long-term trends have the potential to achieve exceptional growth. Furthermore, the application and deployment of artificial intelligence may give their growth an extra boost.

Take Axon Enterprise as an example (NASDAQ: AXON). Axon is the leading provider of tasers and body cameras to US law enforcement agencies. Its innovative AI-powered software, Draft One, uses the vision captured by the Axon body camera to draft police reports, reducing a mundane task that consumes hours of an officer's day. The Fort Collins Police Department has claimed a 67% decrease in time spent by officers writing incident reports since deploying the technology. We believe Axon is at the forefront of modernising law enforcement, with its technology poised to expand into private security, defence, and international markets. We see this as just the beginning of a long growth trajectory.



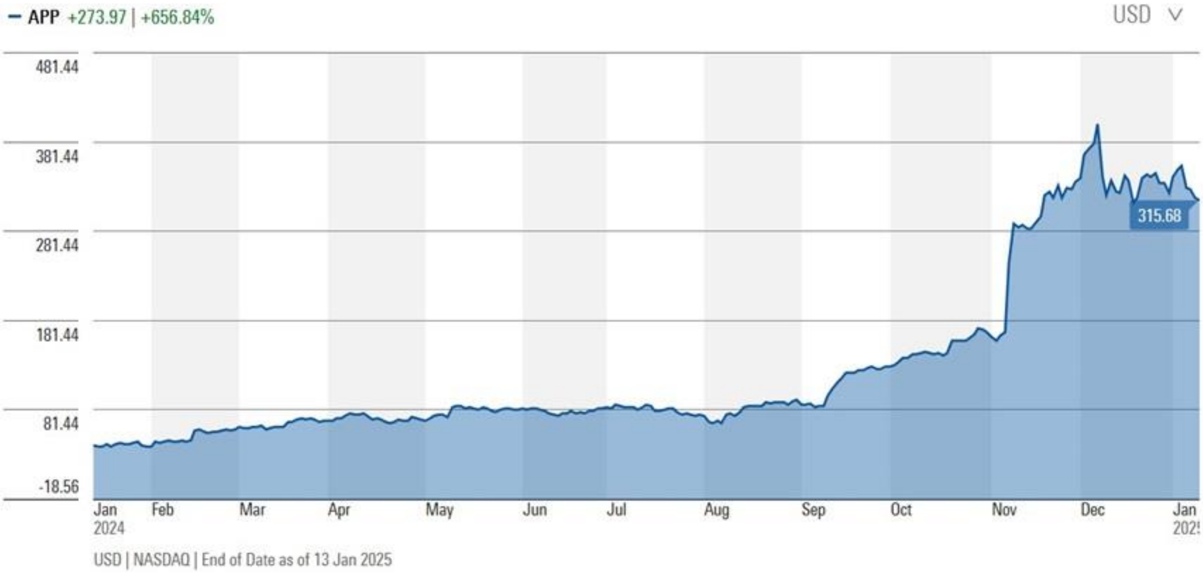
Source: Morningstar.com

RadNet ([NASDAQ: RDNT]) is another example. This company owns and operates diagnostic imaging centres and is pioneering the use of AI in mammography. It developed an AI algorithm that analyses MRI and CT scans with greater speed and accuracy than human radiologists, detecting cancers up to a year earlier and reducing false positives by nearly 20%. This innovative technology has far-reaching implications, with potential applications across various therapies including lung and prostate cancer detection and vascular scans. Furthermore, wider insurance coverage is expected to drive further adoption and growth. We anticipate RadNet's earnings acceleration to continue for years to come.



Source: Morningstar.com

An additional example is AppLovin ([NASDAQ: APP]), a founder-led company based in Palo Alto, California. The Company is a mobile app technology company that provides a platform for developers to help them grow, monetise, and optimise their mobile apps. With approximately 1.4 billion daily active users within their mobile gaming ecosystem, AppLovin has one of the largest user bases in the world, allowing them to take share within the mobile gaming advertising ecosystem, where its improved Axon 2.0 AI model is generating superior returns on ad spend for its advertisers. Axon 2.0 has seen a meaningful step change for the company's financials with accelerated revenue growth, as well as expanding margins and free cashflow. AppLovin is now beginning to test the merits of its Axon 2.0 product outside of mobile gaming, specifically, they are now testing the product for e-commerce advertising. This product remains in beta testing, with initial feedback from advertisers suggesting that the company is gaining a lot of traction, with some sources suggesting their returns are superior to Meta. Advertisers are indicating that if these returns hold, AppLovin could quickly become a large portion of their advertising budgets. This is creating a lot of interest across the industry, with a long tail of advertisers keen to try the platform. We expect, the e-commerce opportunity more than doubles AppLovin's addressable market. The market has become very excited about the e-commerce opportunity, which would be incremental to management's guidance of 20-30% revenue growth over the next few years.



Source: Morningstar.com

Little attention from Wall Street

A significant valuation gap persists between smaller companies and their mega-cap counterparts, presenting a compelling investment opportunity as we move into 2025 and beyond. This disparity is largely driven by a simple factor: lack of attention.

Consider this: when industry giants like Nvidia and Microsoft release their earnings, they are met with a deluge of analysis, with over 40 analysts dissecting every detail of their performance. In contrast, when the smaller semiconductor or software companies in our portfolio report results, they often receive minimal coverage, with only one or two analysts providing limited commentary.

This lack of attention creates an information inefficiency, where the true value of these smaller companies remains obscured from the broader market. This presents unique and significant opportunities for discerning investors seeking strong returns.

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Decoding the DNA of exceptional companies

Lawrence Lam

Why do some companies evolve into wealth-generating engines, while others manage only short-lived growth before fading away? The essence of value creation lies in the series of decisions made by a company's leaders. These choices steer the organisation's course and define its future potential. Ultimately, it is the management team that drives value, determining which products and services to offer, formulating the strategies to win market share, and optimising the use of company resources. In their hands rest the fate of the business. This article explores the role of professional management teams, and by learning how to assess their effectiveness, we can gain the ability to foresee the success of any company.

Executives as wealth creators

It is worthwhile clarifying what is meant by value creation as it may mean different things to different organisations. Value creation in this context is about wealth creation. It can take the form of earnings growth, dividend growth, and stock price appreciation. Exceptional management teams create great companies which, like a planet, attain their own gravitational force to attract talent, capital, customers, and therefore profits. Planets continue gathering their own momentum as they get bigger in size, collecting dust from space over millions of years. Great management teams nurture companies that, once set on the right path, continue snowballing in size by themselves and well into the future. And for those that get it right, the financial rewards for shareholders, management teams, and boards are life-changing – not to mention the value created via their products or services that meet or, even better, exceed consumer expectations.

Take for instance Hermès, the well-known French luxury brand. Founded in 1837 as a boutique harness-maker, the business has evolved from a saddlery in the 1800s into the luxury handbag and clothing company it is today. During that time, it has created immense wealth for its founding family, which today still owns 65% of the available shares. At the end of 1994, it was valued with a market capitalisation of US$1.3 billion. Today, its market capitalisation is around US$220 billion – equivalent to a staggering annual compound growth rate of 19.3% per annum. In addition, shareholders have received significant dividend growth over time.

Hermès's enduring value lies in its brand – it is not a company driven by fleeting trends. Instead, its business value is anchored in a strong brand strategy that will continue to generate wealth for its owners for many more years to come. This success has not been easy to come by; it is the culmination of sound management and long-term decisions that have firmly established Hermès as a symbol of luxury in consumers' minds. In other words, Hermès's current success is the product of an accumulation of wise management decisions made over many years.

The pillars of long-term success

Great companies come from diverse sectors and are led by management teams with varying philosophies and styles. The large body of research on management styles and techniques is directed towards professionals so they can employ them to improve their impact. This is a constantly evolving field in its own right, shaped by the ever-changing nature of human behaviour and societal expectations. However, we are not focused on the nuances of management styles and skills; rather, it is the analysis and assessment of the results that we are interested in. And since we are focused on the outcomes delivered through a management team's skill, there are clear objective tests that can be applied across all sectors and styles to gauge the management team's potential to create long-term value.

The role of management is to steer and grow the company to create long-lasting value. To do that, they need to demonstrate the capability for:

- Bold decision-making
- Motivation for the right reasons
- Commanding the masses.

Regardless of a company's industry or size, these three qualities are essential for effective management teams, forming the bedrock of long-term success and sustainable growth. Hermès exemplifies how the remarkable value created by such companies is deeply rooted in each generation of management upholding these principles.

Here we briefly run through the first of the above qualities that companies need to create value.

Bold decision-making

There are specific moments in a company's history that present a fork in the road for management to decide whether to take a left or right turn. The correct choice generates value, while the wrong choice erodes value. Hermès experienced this in the 1990s when then- CEO Jean-Louis Dumas made the decision to phase out externally owned retail franchise stores while increasing the number of company- owned stores. In the short term this decision significantly increased capital expenditure and reduced sales volumes, but Dumas, being a member of the founding family, had the longer-term goal of elevating the in-store experience. He sought greater control over customer interactions with the brand — and despite the initial cost, the reduction in stores eventually generated an increased sense of exclusivity and brand cachet among customers, leading to an improvement in margins.

This example underscores the value of eschewing rigid conventions in favour of a thoughtfully independent approach. In this instance, what appeared detrimental to the business in the short term was, in fact, the right decision for the long term. Dumas recognised the opportunity to elevate brand perception by limiting volume and enhancing the in-store experience, contrasting sharply with the prevailing strategy of broadening distribution and prioritising expansion. The effects of such decisions may not stand out with great significance by themselves but when stacked on top of each other and compounded over time, they begin sculpting a company's future.

Bold decision-making is not only based on independent logical deduction but having the fortitude to take calculated risks. Far too many bureaucratic companies fall into a culture frozen by conservatism at the board and management level. The appetite to take calculated risks then becomes lost in the aversion to venture off the beaten track, for fear that veering too far from benchmarked competitors automatically puts the company at risk. History is sprinkled with companies that have failed to move or have been too slow to adapt to changing technology (think Kodak or Blockbuster). We want management teams that take calculated risks and will change course if needed.

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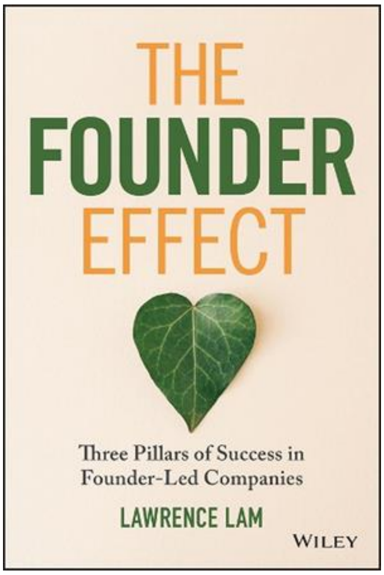
This is a lightly edited extract from *The Founder Effect* (Wiley RRP $34.95) by Lawrence Lam, which explores the essential traits of successful executive teams and governance structures that drive sustainable growth. Author Lawrence Lam brings over two decades of expertise in global equities, risk management, and advising boards on investment strategies. For more information visit https://lawrencelam.org/



*Lawrence Lam is the Founder and Managing Director of Lumenary Investment Management, a firm that specialises in investing in founder-led companies globally. Lawrence's new book The Founder Effect (Wiley $34.95), is out soon. Firstlinks readers can pre-order a copy using the promo code **MAR47587U83B** at checkout for a 10% discount (valid until 29 January 2025).*

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