STANFORD BROWN
Financial Advisers

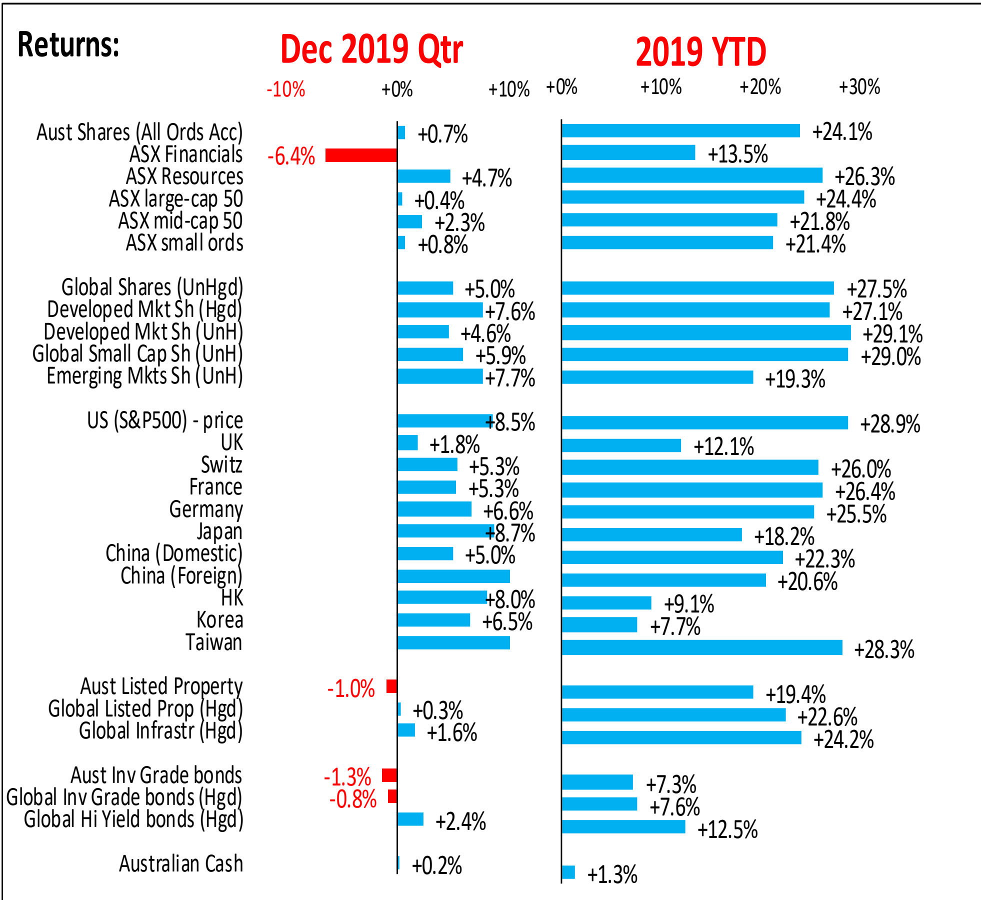
Stanford Brown Monthly Top 5

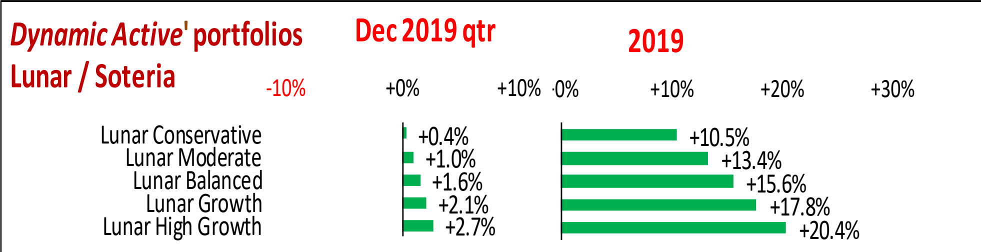
January 2020

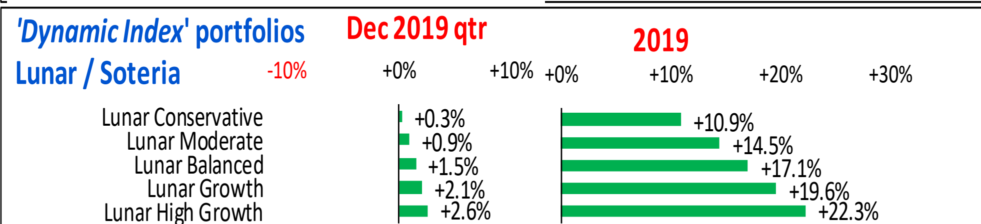
1 Portfolios up strongly in 2019

Australian shares were held flat in the last quarter by heavy falls by the big banks that were caused by increasing pessimism over the likely costs of compliance, regulatory penalties, customer remediation, tougher regulations and higher capital requirements. Most other world markets had a strong quarter, especially in Asia as trade war fears receded when Trump moved toward a trade deal with China. Iron ore prices fell back a little in the quarter but oil prices surged as Middle East tensions hotted up. The general global optimism on the trade war front since early September caused a switch in bond yields – from declining in the first eight months of the year to rising in the last four months. This also drove a late rise in the Australian dollar after it had been declining for most of the year.

For the 2019 year the broad Australian share market had its best year since 2009, returning 24% including nearly 5% in dividends. Australia was one of the weaker developed markets for the year in terms of share prices despite enjoying the strongest economic growth rates, posting rare trade, current account and budget surpluses thanks to surging iron ore prices, low unemployment and inflation rates, a house price turnaround, record low interest rates after three more RBA rate cuts, and a weaker dollar helping exporters.







The best sectors for the local market this year were:

- Healthcare (led by CSL +49%),
- Tech stocks (AfterPay +136%, Xero +90%, Altium +63%);
- Resources (Fortescue +160% and RIO +28% on higher iron ore prices, gold miner Newcrest +39% on higher gold prices, BHP +19%); and
- Telstra +26% on lower bond yields.

Australian shares echoed the general global rally this year which was driven largely by renewed stimulus efforts from the main central banks. After nine rate hikes since December 2015 including four during 2018 which triggered heavy share price falls late last year, the US Fed put rate hikes on 'pause' at the start of 2019 and then resumed rate cuts and 'QE' asset buying during the year. This was echoed in similar expansionary moves in Europe, Japan and China.

US shares were the stars this year – the S&P500 index returned 32% including dividends. The surge was driven mainly by the big tech companies: Apple +86%, Microsoft +55%, NVIDIA +76%, Adobe +46%, Facebook +57%, Alphabet (Google) +29%, but also up strongly were the big banks, credit card companies, and nearly of the all major retailers and consumer brands.

In portfolios – we have been over-weight Australian and global shares from early in the 2019 rebound (a switch from being under-weight when shares sold off heavily in late 2018).

Portfolios also benefited from being under-weight Australian and global bonds this year, although they also posted above average returns for the year thanks to bond yields declining across the board.

2020 will be a different ball game of course as 2019 was mostly just a rebound from the poor returns from shares and bonds in late 2018.

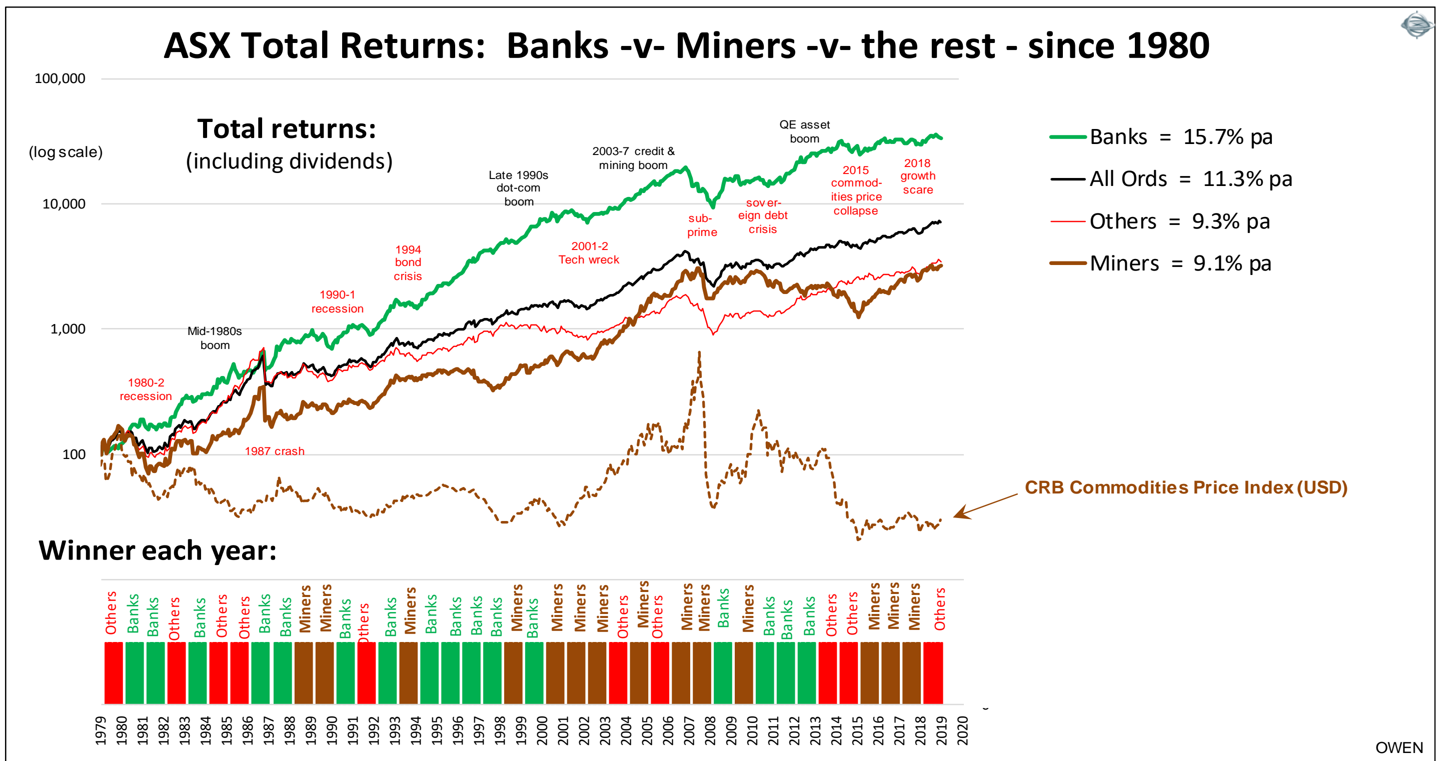
2 Miners strong but pipped at the post

Australian share markets have always been dominated by miners and banks. Australia also once had a host of manufacturers and industrial companies that survived behind high protection barriers between WW1 and the 1980s, but most disappeared when protection was removed in the 1980s. So we are now back to three major segments of the market – banks, miners and the rest, with around one third of the market each.

In most years either the banks or miners have won in terms of total returns, but occasionally the 'others' get up to take the honours.

The chart shows total returns (including dividends) over the past 40 years from banks (green line), miners (brown), and the rest of the market (red), compared to the overall market returns (black). The brown dotted line in the middle section is the broad commodities price index, which is the key to mining cycles and miners' fortunes. The bars in the bottom section show the winning segment for each calendar year.

The banks have won hands down over the past 40 years – with total returns averaging more than 15% per year, compared to just 9% per year for the miners and the 'others', and 11% per year for the market has a whole.



Miners were the winners in 2016, 2017 and 2018 as commodities prices started to rise once again after the Chinese stimulus re-boot in early 2016, assisted also by the Trump election and signs of improvement in demand in the US, Europe and even in Japan.

Meanwhile, the big bank share prices peaked in 2015 and have been lagging ever since.

Who won in 2019?

Miners posted tremendous returns of +26.3% for the year - led by the big iron ore miners (mainly Fortescue and RIO) boosted by the windfall +27% price spike in iron ore following the Vale mine disaster in Brazil which took 93 million tonnes out of iron ore production. Gold miners like Newcrest also rose with higher gold prices. Oil & gas stocks were lifted by oil prices rising +35% as Middle East tensions escalated, and other miners were also strong, except for niche metals like lithium which continued to fall in the global glut and weak electric vehicle sales.

Banks lost as expected, because miners almost always win when commodities prices are rising. We have been bearish on Australian banks for the past three years in this report – for a host of reasons even before the Hayne Royal Commission exposed them as being little more than giant dens of thieves. Banks were the big drag on the local market in 2019, returning just +13.5% as profits fell and dividends were cut.

But the big surprise was that the 'other' segment shot ahead late in the year to post +28.2% returns, just beating the miners for top spot. The stars in the 'Other' team were healthcare (led by CSL but all major stocks were strong), consumer discretionary (led mainly by Wesfarmers, Aristocrat, JB HiFi) and tech stocks (mainly REA, Xero, Wisetech, Afterpay, Altium, and Carsales).

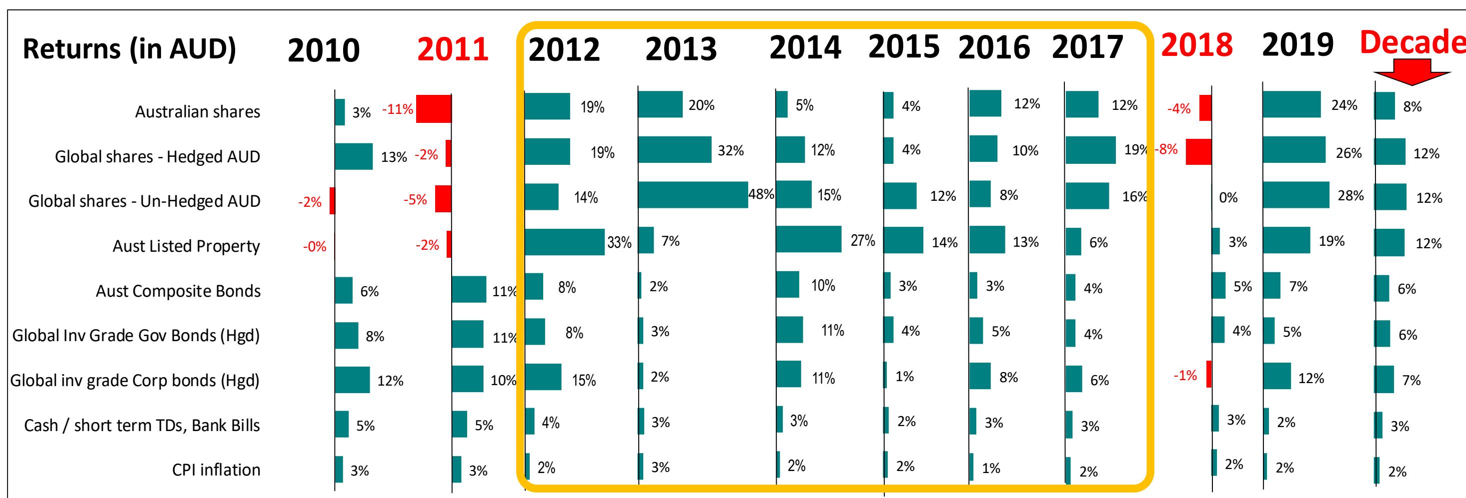
As for 2020? Miners are pretty hard to beat when commodities prices are rising – and we expect commodities prices to be supported by Chinese stimulus, trade war optimism and also the global military build-up. The problems with the banks are partly cyclical (lending growth and interest rates), partly structural (regulation and demographics) and perhaps partly terminal (new forms of competitors). On the 'Other' team we have some great quiet achievers in global leaders like CSL which is not far from becoming Australia's largest listed company.

3 Local shares lag for the decade

In last month's report we looked at how Australian shares performed in the decade in terms of the winners (healthcare, tech, utilities) and losers (miners, oil/gas, telcos, banks). This time we look at how Australian shares fared in relation to other asset classes in diversified portfolios.

Australian shares had a relatively poor decade in the 2010s, with total returns (share price gains plus dividends) of 8% per year. This is below the long term average of around 11% per year. Our 8% from shares for the decade was lower than 12% per year from international shares and Australian listed property trusts. Coming in at 6% per year were Australian and international bonds, but at much lower volatility than shares.

Here are the total returns from the major asset classes (in Australian dollars) for each of the past ten years, and the decade averages at right.



It would have been reasonable to expect that returns from shares would be relatively good in the 2010s because the decade started out from a low base after the sub-prime / GFC share price crash in 2008 and the partial rebound in 2009, but it was not to be.

2010 was a continuation of the 2009 rebound from the GFC collapse, but Australian shares were hurt by four rate hikes by the RBA due to rising inflation in the China-led commodities rebound. Global shares shrugged off the Greek 1st bailout crisis and bank runs in Europe. 2011 was a boom year for commodities prices and Australian company profits but shares prices fell. Australian share prices were affected more than the rest of the world by the Greece 2 and US credit downgrade/debt ceiling crises.

Then came the great 'QE' boom (quantitative easing: central banks buying assets with newly printed money to force down interest rates in order to entice people to buy shares – which they did!). The result was a six-year run of positive real (after inflation) returns from all main asset classes. This had never happened before and, as we noted at the time, would probably never happen again. The previous record was four consecutive years of positive real returns from shares and bonds in 1925-1928 and that was followed by the 1929 crash and 1930s depression.

The six year 2012-7 boom in shares and bonds was not without a host of crises and scares along the way, but they were more than offset by the flood of cheap money from central banks in the form of zero and negative interest rates (and rate cuts here from the RBA) plus 'QE' bond buying programs, as well as the equally powerful flood of money from deficit-funded government spending sprees.

In 2012 there were bank runs in Greece and Spain, and the US QE 'taper tantrum' when it scared markets by hints of reducing QE. In 2013 we had the Cyprus bank crisis, Italian election chaos, more US QE taper scares and the US government shutdown when the government literally ran out of money. In 2014 Russia flexed its muscles by invading Crimea, US ended QE and planned to start raising rates. In 2015 commodities prices collapsed with fears of a slowing China, and the Fed finally started hiking interest rates. In 2016 the China stimulus re-boot ended the commodities price collapse but we had the Brexit vote, the Trump election and anther Fed rate hike. In 2017 we had the Trump tax cuts and spending sprees, but also three more Fed rate hikes, and the ECB started to talk about ending its QE program.

In the January 2018 edition of this report we suggested that it was probably the end of the great six-year golden era for returns. And it was.

In 2018 share prices fell everywhere and bonds also posted low returns - an unusual combination. The triggers were four more rate hikes from the US plus slowdown fears in China, stagnation in Europe and Japan, fears of slowing growth in the US, and Trump started his trade wars.

We protected investors in our portfolios from most of the pain by significantly reducing Australian and international shares prior to the 2018 sell-off. On the defensive side, instead of loading up on bonds as a defence against the share sell-off, we were wary of inflation concerns (which hurt bonds) so we bought US dollar cash and Australian dollar gold – and they both jumped 10% in the crisis. In our reduced holdings of international shares we heavily favoured being un-hedged on the currency risk, and this paid off as the 8% fall in international shares was completely neutralised by similar falls in the Australian dollar, so our un-hedged international shares avoided the losses.

In 2019 we returned to more normal settings and increased weights of shares for the rebound. As for the next decade?

In order to form a view about likely future returns we need to understand the sources of returns. We do this in the next story.

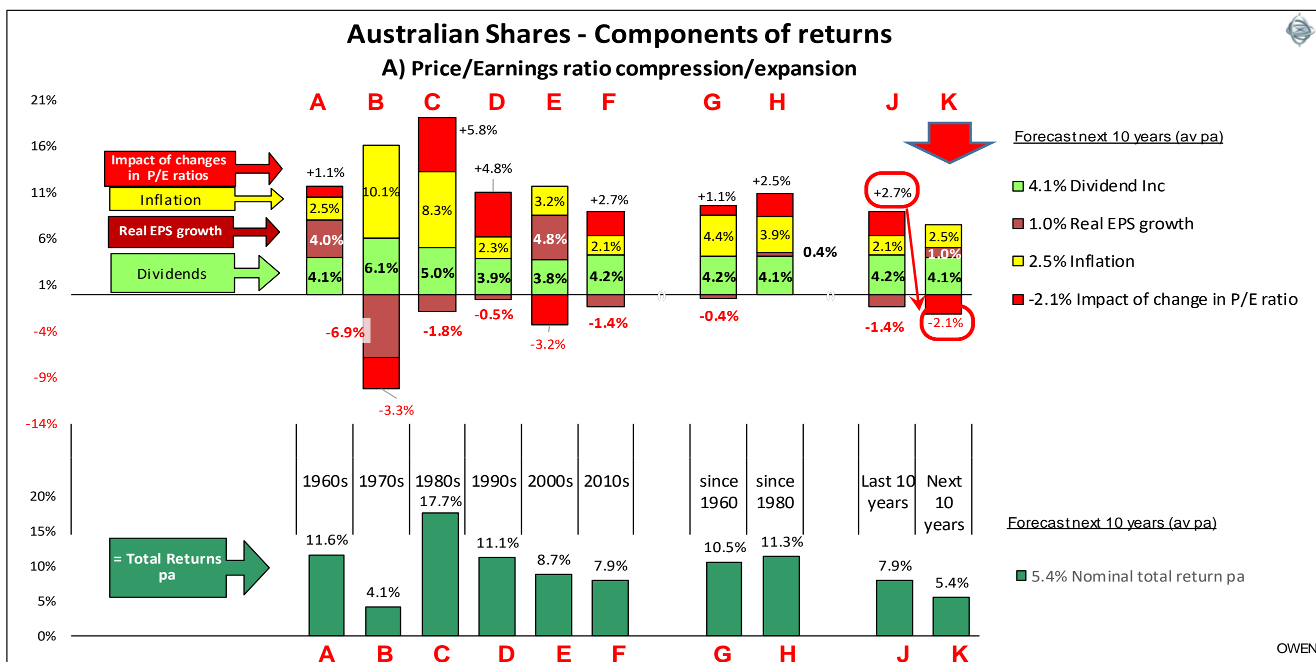
4 Where do share returns come from?

(or more correctly: 'From whence to share returns come?'

The chart in our second story above showed that the broad Australian share market generated total returns (share price gains plus dividends, but before tax and franking credits) averaging 11.3% per year since 1980. It is very tempting to simply assume that because the market has generated these good returns for such a long period, then it would be reasonable to expect this to continue over the next 10 years or so.

This is too simplistic. We need to understand the different sources or components of returns in order to see what gave rise to them, and then to assess whether each of the components is likely to continue in future at the same rate, or higher, or lower, or maybe even reverse direction.

The chart below shows the sources of returns by decade since 1960 (columns A to F). Column G shows the average since 1960. H is since 1980 – which breaks up the 11.3% from the prior chart. Column J shows the most recent 10 years (which in this edition is the same as the 2010s decade, column F), and K shows a forecast for the next 10 years. The bottom section shows average annual total returns in each period.



The first observation is that not only do the total returns to shareholders vary significantly in each decade, the sources differ even more greatly.

Total shareholder returns over the past 10 years averaged 7.9% pa (column J), which is lower than post-1980 average of 11.3% (H). The main reason was that inflation (yellow bars) was lower over the past decade than it was since 1980. These returns came from the following sources:

- Dividends contributed 4.1% pa since 1980 and 4.2% pa over the past decade. This is the only component of returns that is likely to be sustainable at similar levels in the next 10 years (and is the only component that has been reasonably consistent over the prior century as well).
- Inflation contributed 3.9% pa since 1980 but only 2.1% over the past decade. Inflation over the next decade will probably average say 2.5%
- Growth in real (ie excluding inflation) earnings (profits) per share contributed only +0.4% pa since 1980 and a negative -1.4% per year for the past decade. This is a very poor indictment of management of Australian companies over the past 40 years – to consistently fail to grow real profits per share even though the total economic pie in Australia has been growing by more than 3% per year (real GDP growth).
- Changes in price/earnings ratios – ie changes in the amount of money investors are willing to pay per dollar of profits. This contributed another +2.5% per year since 1980 and +2.7% per year over the past decade. Price/earnings ratios were 7.5 at the start of 1980, and 15.2 at the start of the last decade, but the ratio is 19.8 now. This means that investors paid $15.20 per dollar of company profits at the start of 2010 but they are willing to pay $19.80 per dollar now, which pushed share prices up by 30% (or 2.7% pa) for the same level of profits. People feel richer when they look at their share prices, but it is an illusion. They simply paid 30% more for the same profits than they did 10 years ago.

For this illusory price gain to continue, we would have to pay another 30% more per dollar of profits in the next 10 years – which would push the ratio up to an even more expensive 26 times profits. Even if the ratio stayed flat at the current expensive 19.8, it would mean returns are going to be 2.7% lower than last decade. A more realistic assumption would be that the current 19.6 price/earnings ratio is unsustainably high and would probably fall back to say 16 (still above the historical average of 14). This would reduce returns by another 2% per year.

And so to the forecast – If we assume dividends at around 4%, plus inflation of around 2% to 2.5% (many would argue that is ambitious) plus real earnings per share growth of say 1% or perhaps 2% pa (since we are now in a profit slump), we get 7-8% total returns IF price earnings ratios remain flat – which is highly unlikely. If price earnings ratios reduce back to 16, that knocks 2% off returns – to get say 5-6% pa. This is a sobering prospect but it forces us to look at how returns are generated rather than simply relying on history to repeat. It rarely does.

5 IPOs – a new elephant in the room

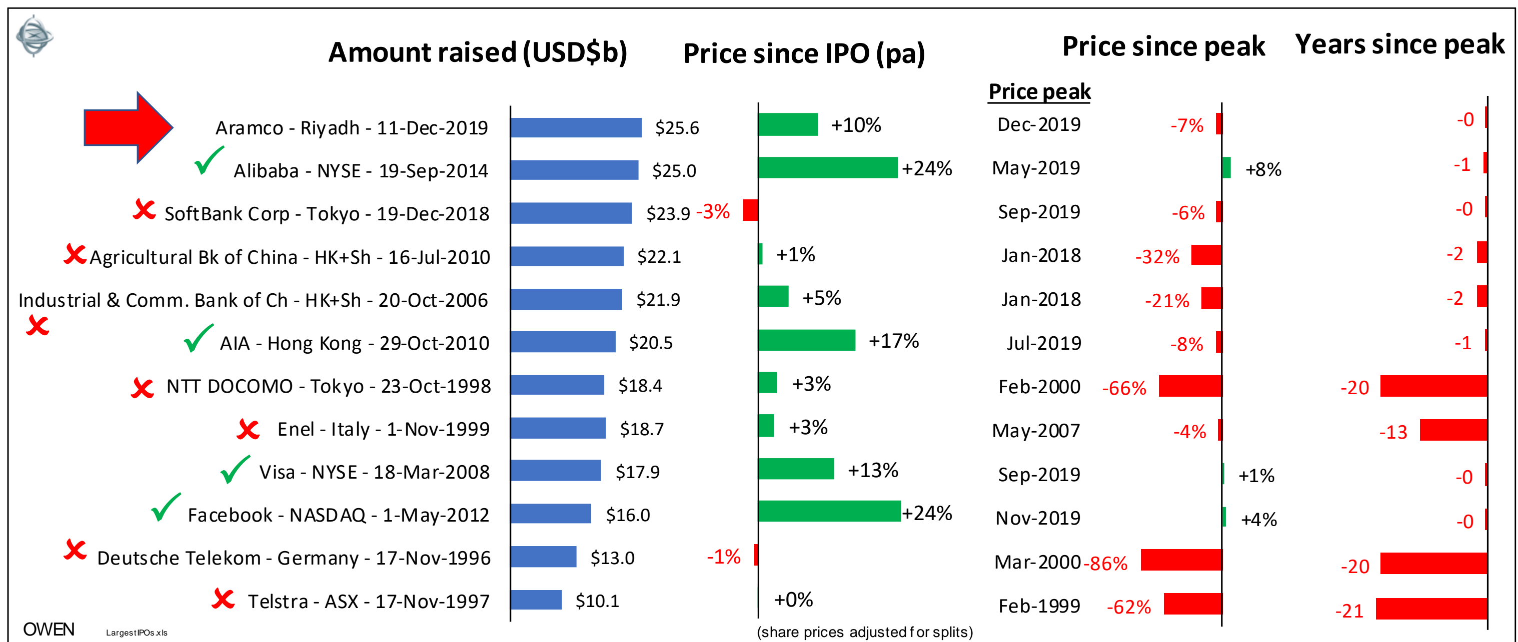
2019 was a year of big IPOs (initial public offerings for shares in companies to become listed for the first time).

In December a new record was set for the world's largest IPO when The Saudi Arabian Oil Company (known as Aramco) raised US$25.6b for just 1.5% of the company. The float was disappointing for its owner, the Saudi Arabian government. It had grand plans of selling 4.5% of the company to investors all over the world and listing in New York, but a general lack of interest meant it sold just 1.5% of the company, mainly to locals, and listed on the tiny Tadawul exchange in Saudi Arabia. Although the oil price had jumped by a handy 35% during 2019 due to rising US-Iran tensions and OPEC production cuts, oil producers are on the nose with investors everywhere as the world shifts away from fossil fuels.

For the Saudi government it was probably a good time to sell down and get some cash out. Although oil is probably in terminal decline as a major fuel source, Aramco is still by far the most profitable company in the world. Last year it made $111b in net profit from $360b in revenues, which is double that of Apple ($55b net profit from $260b revenues), and three times Microsoft ($39b net profit from $126b revenues). Apple and Microsoft had been tussling all year for the title of world's largest listed company until they were swamped by Aramco when it listed.

Retail investors tend to get excited by IPOs and often jump in for 'fear of missing out'. But are we excited by Aramco? Who would want to be a part-owner of a one-product business that does nothing by pump out fossil fuels, and dominates an industry that is probably in terminal decline?

IPOs have a long sorry history of under-performance. The bigger they are, the more the hype, and the greater chance of disappointment. Here are the 12 largest IPOs in the world (measured in US dollars). The second column shows their share price gains per year since IPO. The third column shows the share price changes since their peak, and the right columns shows the number of years since their share prices peaked.



Prior to the Aramco float in 2019, the record was held by Alibaba – the Chinese internet firm that is now the 10th largest listed company in the world, with a market value of US$600m (nearly half the size of Apple and Microsoft, and not far behind Facebook). Alibaba's US IPO in 2014 was the largest IPO up to that point, larger than the Google, Facebook, and Twitter IPOs combined. It is one of the few successful IPOs on the list.

In November 2019 Alibaba also raised another US$13b in Hong Kong and listed its shares on the Hong Kong exchange. It was originally listed in New York in 2014 because the NYSE had looser listing laws that allowed different voting rights for different classes of shares (this is a common ploy used by many US tech companies to enable their founders to continue to control their companies rather than being answerable to pesky shareholders who contribute actual cash). Alibaba's Hong Kong listing in 2019 was made possible when Hong Kong loosened its laws to allow dual class shares, but it is also part of a broader theme of Chinese companies 'returning home' as world power balance shifts from the US to China.

Australia's largest IPO was Telstra (the 12th largest ever IPO in the world). Telstra's 'T1' offer on 17 Nov 1997 raised AUD$14.3b at $3.30 per share for one third of the Commonwealth government's holding (the equivalent of US$10.1b at the exchange rate at the time). Unfortunately the share price today is still barely above its IPO price 22 years later. It has been even worse for the hapless buyers of the 'T2' round at $7.40 in October 1999. Telstra's share price is still 60% below its peak price of $9.20 reached 21 years ago at the height of the 1990s 'dot-com' boom.

Darlings and dogs

Only 4 out of the 12 largest IPOs in the world have been winners for the initial IPO shareholders. Two of the four winners are Chinese: Alibaba and AIA Insurance (Hong Kong-based insurance giant). The other two winners were American – Visa and Facebook. The other well-known US tech giants do not make the list as their IPO raisings were relatively small – Google raised $1.9b in 2004, Amazon raised just $54m in 1997, Microsoft raised $61m in 1986, and Apple raised $100m in 1980. Even adjusting for inflation these are still very small compared to the top-12 list.

The two big Chinese banks on the list have been poor investments. Their IPOs were dressed up with a great deal of hype but were essentially just a way for the Chinese government to get foreigners to re-capitalise their old dinosaur state-directed banks after the banking collapses from an orgy of bad state-directed lending to state-directed political pet projects.

Deutsche Telekom (Germany) and NTT DOCOMO (Japan) were opportunistic sell-downs – like Telstra - to take advantage of the irrational dot-com boom frenzy of the late 1990s. (Believe it or not, Telstra was the hottest of hot 'dot-com' bubble stocks in the late 1990s and its price bubble made it the largest listed company on the ASX. Rupert Murdoch's News Corp was a close second – also considered a 'dot com' star!).

SoftBank Corp was another opportunistic sell-down by its parent Softbank Group, which itself was another dot-com bubble stock in Japan and its share price is still more than 80% below its dot-com peak in 2000. Softbank Corp specialises in investing in tech start-ups – and has incurred some big losses and write-offs to date – including the failed WeWork IPO in 2019.

2019 also saw some winners and losers. Car sharing apps Uber (raised $8.1b, and also a source of losses for Softbank) and Lyft ($2.6b).are both down heavily, while Tradeweb ($1.2b) and Pinterest ($1.6b) are up so far.

It is important to remember that short term share price performance is not necessarily an indicator of longer term outcomes. Facebook's share price fell by 50% in virtually a straight line downward in the months following its 2012 float, but then soared back more than ten-fold to its current heights. The difference is that Facebook was profitable from the day it listed, but Uber and Lyft look like being years away from any profits. Conversely, Amazon lost money for 16 straight years after its 1997 listing but it has turned out to be one of the greatest success stories for IPO shareholders of all time.

When investing in IPOs it is critical to look behind the fancy marketing hype and focus instead on the underlying business and the track record of the founders. This is the same as with any investment but is often more difficult with IPOs because the business and their founders have limited or no track records.

With IPOs it is important to ask two additional questions: 1: Where is the money going? (into vendors' pockets, or into the company); and 2: Why are they selling shares to the public? (if the business is half as good as their slick marketing hype says it is, why are they so keen to sell it to me?).

Later this year we will take a look at the track record for IPOs in Australia. There have been some brilliant successes but also a sea of red ink.

What lies ahead?

The next decade will probably feature three broad themes arising from the last – and each has important implications for long term investors.

First, on the economic and financial front, the 2010s will be remembered as the decade of central bank experiments – with zero and then negative cash rates – but with little or no net positive effects. Central banks also bought up assets with newly printed money ('quantitative easing' or 'QE') – also with little or no net positive effects. History will not be kind to central bankers in the 2010s for their efforts. Europe, Japan and the US have become addicted to the sugar hits of cheap and free money, and similarly China has become heavily reliant on state-directed stimulus projects to prop up ailing growth. All are still stuck on life support and all have had trouble weening themselves off it.

In Europe interest rates were raised prematurely in 2011 but it sent Europe back into recession and they had to resume rate cuts and ramp up QE. Europe tried to ended QE asset buying in 2018 but it had to hastily restart in 2019 to revive sagging growth. Japan tried to raise taxes prematurely in 2014 and it also sent Japan back into recession and they had do kick-start 'Abenomics' – several times. (Japan has been using QE since the early 1990s but the economy is still flat-lined three decades later). China tried to scale back stimulus projects in 2013-5 but the resulting slowdown scare led to a commodities price collapse that triggered a global oil/gas/steel bankruptcy crisis that caused a global 'earnings recession'. China had to kick off another stimulus re-boot in early 2016 but that has just added to mounting pile of bad debts to failed industries propped up to save jobs. The US Federal Reserve started raising rates from December 2015, ended QE and started to reduce its balance sheet, but it too had to rapidly reverse course in 2019 and re-resume rate cuts and asset buying to prop up weak growth.

On top of the economic side-effects of the decade of ultra-low rates and QE, they also created asset bubbles everywhere – and central bankers are now terrified of the knock-on effects of asset price collapses if and when they pull the plug. After a decade of experiments, central banks have learned that zero/negative rates and artificial asset buying create as many problems as they solve. They are left with no solutions (apart from even more debt) and very little ammunition to counter the next crisis when it arrives.

This is important for investors once we look behind the seemingly good asset returns over the past decade and see that much of the returns from shares, bonds, property and many other types of investment asset are the result of people simply paying more or the same level of dividends, interest and rents – driven to do so by central bank experiments. The asset returns achieved over the past decade can only continue at the same pace if ultra-low interest rates and QE remain in place. That will be only if the US, Europe, Japan and China continue on life support mode with weak growth, low business and consumer confidence, weak borrowing, spending and investment, and low inflation.

This is in fact our base case – except for the US which will probably lead the path back to growth. The next decade will probably be peppered with various attempts by central banks and governments to ween themselves off life support – with varying degrees of success and failure and probably a good mix of unexpected side-effects to deal with. This type of environment will create as many opportunities as risks for investors.

Second - we are also likely to see a steady rise in the military and hi-tech cold war between the US (the incumbent sole world power) and China (the regional challenger in Asia). As with the last cold war in the 1950s to the 1980s we are likely to see a variety of proxy wars and skirmishes fought at the periphery – like Korea, Vietnam and the Middle East last time. This should support commodities prices – which is good for commodities exporters like Australia and other emerging markets. The inflationary effects of military build ups and wars is what central bankers dream about, but it presents risks for investors that we haven't seen for several decades.

Third - the past decade will also be remembered as the beginning of the end of the post-1980 era of globalisation, deregulation, lowering of protection barriers, tax cuts, oligopoly corporate profiteering, the shift of manufacturing and wages from the 'west' to the 'east', and the 'uberisation' of the remaining jobs thanks to the tech boom. All of this resulted in the decline of the middle class (while the billionaire class boomed) in the west, and the rise of middle class and billionaire class in the east – especially in China.

The collapse of the financial system in 2008-9 was the start of this political shift. A decade of post-GFC stagnant growth, rising debt levels and stagnant wages fuelled widespread disillusionment with post-1980 globalisation and the 'elites' who were seen to have reaped most of the benefits; and a shift toward populist nationalism, xenophobia and protectionism, which in turn fuelled a global power shift away from moderate parties and toward radical left and right wing parties and leaders across the world. Trump, Johnson, Putin, Bolsonaro, et al did not create or lead this global shift. They are tapping into, and being swept along by, the global tide that will continue long after the current leaders are gone.

Each of these three great themes in the next decade presents threats and opportunities for investors. We cannot predict the future but we do have a range of tools to assess the surrounding landscape and also the ability to adjust portfolios to navigate through the terrain.

'Till next time, happy investing!

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