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Firstlinks Interview Series

A collection of recent and classic interviews published by Firstlinks

2013 – 2019

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Introduction

Graham Hand

It's fitting that we should start the Interview Series with Nobel Laureate, Harry Markowitz, who was born in 1927 and is now 92 years-of-age. Markowitz was only 22 when he realised that an efficient portfolio should maximise the expected return on assets for a given level of risk. Although a theoretical framework, his Modern Portfolio Theory has been taught to investors for almost 70 years. Like most of the best insights, it is a simple idea, focussing on risk and return trade-offs.

Markowitz told me he started in securities analysis by accident.

"I was a PhD candidate at the University of Chicago and had to choose a topic, so I went to see my supervisor, Professor Jacob Marschak. He was busy so I sat in this ante room, and another man was there who was a broker. He suggested a dissertation on the stock market. That's the best advice a broker has ever given me."

In the 30 interviews in this ebook, we uncover many of the secrets that investment managers have taken decades to learn. We feature globally renowned experts such as Burton Malkiel, Sir Michael Hintze, Professor Elroy Dimson, Robert Kitces and Nobel Laureate Robert Merton, as well as high-profile local fund managers covering every asset class.

We can all benefit from this vast experience. As Markowitz said, paraphrasing Sir Isaac Newton, "*I saw so far because I stood on the shoulders of giants.*"

Managing Editor Graham Hand with Harry Markowitz (left), Nobel Laureate and father of Modern Portfolio Theory, and Burton Malkiel (right), author of global bestseller, 'A Random Walk Down Wall Street' *in San Diego, USA in 2013.*

The Harry Markowitz Interview, Parts 1 and 2

Portfolio selection, 10 May 2013

At the 2013 Research Affiliates Advisory Panel meeting in San Diego, I interviewed one of the doyens of the wealth management industry, the 1990 Nobel Prize Winner, **Harry Markowitz.** His 1952 seminal paper *Portfolio Selection* pioneered our understanding of risk, return and correlation in investment portfolios. His Efficient Frontier and Modern Portfolio Theory ideas are still taught in universities and business schools.

Harry Markowitz was born on August 24, 1927 in Chicago. He studied economics at the University of Chicago under important economists, including Milton Friedman. While still a student, he was invited to become a member of the prestigious Cowles Commission for Research in Economics, leading to his 1952 breakthrough work.

Markowitz now divides his time between teaching (he is an adjunct professor at the Rady School of Management at the University of California at San Diego) and consulting (out of his Harry Markowitz Company offices). He is co-founder and Chief Architect of GuidedChoice, a managed accounts provider and investment advisor. Markowitz's more recent work has included designing the software analytics for the GuidedChoice investment solution and heading the GuidedChoice Investment Committee.

One amusing moment from the Conference shows how competitive and bright the 85-year-old Markowitz still is. The 2011 Nobel Prize winner, Chris Sims, had just finished a highly technical presentation on how fiscal policy affects inflation. As he paused for questions, Harry was first in. "Now we know how you got your Nobel Prize, let me show you how I got mine." And he gave his critique of the presentation as if giving a lecture in his university.

Graham Hand: I'd like to start by going back to 1952 and your seminal paper, *Portfolio Selection*. Did the idea of mean variance and efficient frontier and risk reward come to you while you were having a shower, or was it more systematic that that?

Harry Markowitz: There was a moment of truth, a 'ah ha' moment. Let me give you some background. I was a PhD candidate at the University of Chicago and had to choose a topic, so I went to see my supervisor, Professor Jacob Marschak. He was busy so I sat in this ante room, and another man was there who was a broker. He suggested a dissertation on the stock market. That's the best advice a broker has ever given me.

I suggested this to Marschak, and he said Alfred Cowles (who set up the Cowles Commission at the University) had always hoped people would do that. Cowles was one of the first to study how successful stock pickers were (and he found they weren't), his work became part of the development of the S&P500 index, but he was also a scholar. Marschak did not know the relevant literature so he sent me over to Professor Marshall Ketchum. He was Dean of the Business School at the time. He gave me a reading list which included Graham and Dodd, Weisenberg and John Burr Williams, *The Theory of Investment Value,* from 1939.

So I'm in the Business School Library, and Williams says the value of a stock should be the present value of its future dividends. I thought to myself, dividends are uncertain, so he must mean the expected value. So I thought if we're only interested in the expected value of a stock, we must be only interested in the expected value of a portfolio, but to maximise the expected value of the portfolio, you must put all your money into the one stock with the highest expected return.

But that can't be right, everyone knows you should not put all your eggs in one basket, Weisenberg had shown people are willing to pay for diversification. So people diversify to reduce risk and volatility, and standard deviation is a measure of risk.

GH: So you knew statistical theory, you had that background?

HM: Yes, I had the usual courses you'd expect from an economics major in the leading econometrics school. So I visualised the returns on the securities as random variables, so that means the return on the portfolio is the weighted sum of the returns on those random variables. I know what the expected value of a weighted sum is, but I don't know off hand what the variance of a weighted sum is. So I get a book off the library shelf, *Introduction to Mathematical Probability*. I look up the formula for the variance of a weighted sum and there it is, covariance. Not only does the volatility of the portfolio depend on volatility of the individual securities, but the extent to which they go up and down together.

GH: That was the magic moment.

HM: That was the moment. So now I have two quantities, risk and return, and I know economics so I draw a trade-off curve. I'd heard of efficient and inefficient allocation of resources, Pareto optimums and so on. So I now had efficient and inefficient portfolios. In that flash, in that moment, much of Markowitz 1952 came together.

GH. So although there was this moment, there was a massive body of knowledge already built up.

HM. Sir Isaac Newton said, "I saw so far because I stood on the shoulders of giants."

GH: Also in your career, you are credited with running one of the first hedge funds, doing arbitrage.

HM. No, a long way from the first. A bit of history. My first job out of college was with the Rand Corporation, where I developed a programming language called SIMSCRIPT, for simulation. The guy who wrote the manual was an entrepreneurial-type, he said, "Harry, let's form a company." We founded CACI in 1962, it still exists, it's a big company now. Then UCLA invited me to be a full professor, full tenure, and another entrepreneur decided to form a hedge fund called Arbitrage Management, based on Thorp and Kassouf's book, *Beat the Market*, doing all sorts of arbitrages. I was a

consultant, then the portfolio manager. We made a decent return for clients but not really for us, we were generating a lot of brokerage, so we became a wholly owned subsidiary of a brokerage house before I left.

GH: Given it's now 60 years since *Portfolio Selection was published, d*o you feel any sense of disappointment about our profession, we haven't really had any major breakthrough theory of investing since the 1950's.

HM: A lot has happened. We have a lot of data now. In 1952, we hired a student to collect data on securities. But between the top down view, knowledge of data, and our experience, we are better now. When I was at Rand in 1950, I just did 50/50. That's all I knew then, it's not what I would do now and it's not what I would recommend to a 25 year old. My profession and I have learned a lot.

GH: I don't like how so many investment discussions end up talking in generalisations.

HM: It's a good point. There's a big difference between my article of 1952 and book of 1959. In chapter 13, I talk about the division of labour between the computational part and the intuitive part. Computational part can show probability distributions of returns you can have at your disposal, we can tilt them so they're correlated with inflation or whatever. But which particular probability distribution you want to have at this time of your life, for this year – you know, your kids go to college, you're not feeling well, people might be dying in your family, etc. - is beyond any model. We don't understand all that goes on. If we could understand it, we couldn't model it. If we could model it, we couldn't estimate it. This year is different from next year.

Retail financial advice, 17 May 2013

This is the second part of my interview with one of the fathers of the wealth management industry, the 1990 Nobel Prize Winner, **Harry Markowitz.** His Modern Portfolio Theory ideas are still taught in universities and business schools. In Part 2, we discussed his retail financial advice business, GuidedChoice. He is co-founder and Chief Architect, including designing the software analytics for the investment solution and heading the Investment Committee. Part 1 of the interview on portfolio selection is here.

Graham Hand: Can we talk about you do with GuidedChoice? I'm especially interested in how you advise people, how you manage asset allocation and issues such as longevity risk.

Harry Markowitz: What we do is Monte Carlo analysis to get a probability distribution of how well you will do if you invest in a certain way and save a certain amount of money. You're familiar with Gary Brinson's writings on asset allocation?

GH: Where 90% of your returns come from asset allocation, not manager selection.

HM: Yes. The important thing about Gary Brinson's work, which has persuaded trillions of dollars of funds to do this top down analysis, is where you first decide to be on an efficient frontier at the asset price level. Then you figure out where you should invest, you might consider the managers to use or ETFs. The beauty of that is that people who have no ability to pick stocks can still get good advice.

We do this top down analysis, for all our clients, we do forward-looking estimates of variances and covariances. We don't reestimate values very often because we use long-dated series. A few years back we said we've got to reduce our forward-looking estimates on fixed income because we're obviously in a low rate environment, but we don't change equity estimates very often. We are doing principal component analysis of the factors, but it's not completely mechanical. When it's finished, we take all the asset classes with estimated expected return on one axis and estimated standard deviation on the other axis.

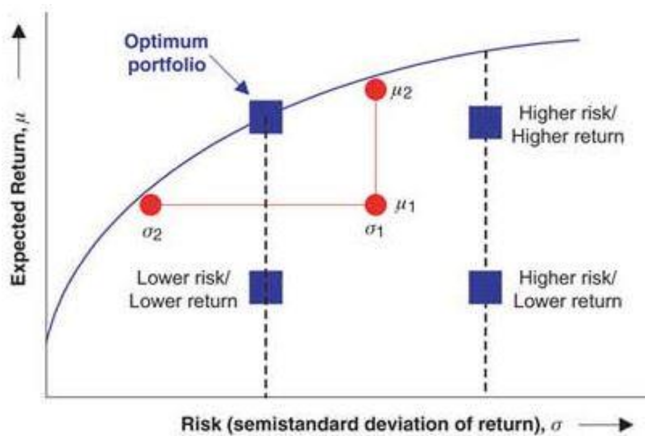
For everybody, we generate an efficient frontier at the asset class level, and we pick off 7 portfolios, number 7 being the riskiest, 1 being the most cautious. Then for specific plans, which have allowed investments, we have a separate optimisation which tries to figure out what are the real investible securities permitted by particular plans in order to match these asset classes. We take into account tracking error, expense ratio, historical alphas. For each participant, we receive a lot of data from their company, and we ask questions like, "When do you plan to retire?"

GH: So there's a type of online questionnaire that the individual fills in? I'm wondering how you work out the client's risk appetite.

HM: Yes, it's interactive online, but we do not ask whether you sky dive. We look at what you already have in your portfolio, assess your current risk level, and we propose to you a portfolio. Then we show you the consequences of changing from your current one to a proposed portfolio. We show you three points on the probability distribution of how much you can spend in current dollars when you retire – in a weak market, an average market and a strong market. You can fiddle with it, you can go up the frontier, or you can save more.

GH: You have these 7 asset class portfolios with different risks, how does someone decide?

HM: You're a client, you've told us when you want to retire, you've said at what rate you are willing to save, told us whether you have a spouse, we can see your existing portfolio. We show you a portfolio which has a similar risk level but maybe a bit more return, and we show you three points off the probability distribution showing the rate you can spend when you retire. You might not want Risk Class 4, so they try 5, and we go back and forth.



Source: GuidedChoice website.

As an aside, you should read a paper I wrote called *The Early History of Portfolio Theory 1600-1960*. I chose 1960 because that was when Bill Sharpe knocked at my door and asked what he should do his dissertation on. And 1600 is when *The Merchant of Venice* was written and Antonio said, *"My ventures are not in one bottom trusted, nor to one place; nor is my whole estate, upon the fortune of this present year."* Shakespeare knew about diversification.

GH: So portfolio diversification had already happened by 1600. How far have we come since then?

HM: Well, now we know how to measure covariance. We know diversification will eliminate risks if they're uncorrelated, but not if they're correlated.

Another thing I should say is that GuidedChoice now has another product, GuidedSpending, which has to do with how fast you can spend in retirement. We assume your spending rate will depend how well you do in the market, and we ask you for two consumption levels: upper level where you can put away any surplus for a rainy day, and a lower level where you have to see if you can hold out for a while. Depending on how you set your levels, plus all the other factors, we assign a probability distribution on the rate at which you can spend when you retire. For any time pattern of consumption, we assign a utility based on the average consumption you can achieve.

GH: But how do you plan for how long a person is going to live?

HM: Currently, we assume you will drop dead precisely 10 years after your actuarial time, but I have been promised some day we will have a stochastic model.

GH: So you use actuarial life tables. What do you think about the basic default savings plans, such as the 60/40 model or lifecycle funds with more allocated to the defensive asset over time?

HM: The problem with 60/40, it's a little chicken for people early on, it's not right for everybody. 90/10 might be best for a young person. The problem with lifecycle is I'm 85 and I have more in equities than I've ever had, but I have a wealth level that means I am many standard deviations away from not being able to eat.

GH: So you need to consider your income-earning ability and other factors, not just your age.

HM: You need to look at the probability distribution of what they can spend, what they can earn, how long they will be employed. Our models will always be grossly inadequate because there are more things on heaven and earth than we can ever capture in our models. We have to do the best we can but we get a lot closer than 60/40 for everybody.

GH: What do you think of the merits of Tactical Asset Allocation where someone takes a view on the market and changes the asset allocation?

HM: There's my official view and my unofficial view. My official view is that nobody seems to be very good at picking the market. But it does seem plausible that when price earnings ratios are historically high, we should lean towards less to equities. In my own funds in 2007, I sold my ETFs, I didn't get out of equities completely, and I went back in in December 2008 expecting a January effect. Which came in March. On some occasions, it has merit. But if someone reads a weekly newsletter about whether you should be betting up or down this time, going in and out, you'll lose money on average over the long run. There's a wonderful behavioural finance guy, Terrance Odean, who studies the track records of individual investors, and he finds both active and passive investors gross roughly what the market makes, the active do worst due to brokerage.

You know, I'm writing another book, in 4 volumes, first is already at the publishers, McGraw-Hill. The next volume is due March 2015, then 2017, then 2019.

GH: That's a good note to end on. Thanks very much, I really appreciate it.

The Burton Malkiel Interview

24 May 2013

Graham Hand: Thanks for signing my copy of *Random Walk.* Note it is the sixth edition from 1996 so I didn't just buy it for you to sign. And your book's now into its 10th edition.

Burt Malkiel: And I'm about to start working on the 11th edition.

GH: Can you tell me what's changed in investing over the decades since the first edition?

BM: What's changed is that the first edition, there were no index funds. First edition was in 1973, the first index fund was in 1976. It is meant to be an investment guide, and there have been dramatic changes in the kinds of instruments available to investors.

There are three major things I do in different editions. One, the new instruments available. For example, more recent editions have featured ETFs. Two, the changing regulations like tax laws facing investors. Then finally, the academic research over the period. Two things I will put in the 11th edition are the low volatility products available, and I think that option writing is interesting. I have some colleagues who have done fascinating research that they can replicate the hedge fund index and get 300 to 400 extra basis points by writing puts. You're basically selling insurance.

You know, in the early days when I said "Just go and buy index funds", I had a reviewer say in Business Week, "This is the biggest load of garbage", so I keep saying, "I said go buy index funds, did it work?" and every time I look at the last four or five years, yes it did work. The book has changed a great deal, but the basic message hasn't changed, even if the advice on what to use has changed.

GH: If I look at some of the criticisms of the book, where people say there are some managers who have had long-term success outperforming the market, but as I read your book, you acknowledge this. For example, in my edition it says, "I walk a middle road. I believe that investors might reconsider their faith in professional advisers, but I am not as ready as many of my academic colleagues to damn the entire field. While it is abundantly clear that the pros do not consistently beat the averages, I must admit that there are exceptions to the rule of the efficient market. Well, a few." So you're not just an efficient markets person.

BM: And that was actually another change. I'm not saying you should necessarily index everything, but there's enough evidence in favour of it, the core of your portfolio ought to be indexed, and then if you want to trial something active around the edges, you do so with much less risk. But just remember, there is this distribution of returns (Burt draws a normal bell curve, then a vertical line near the y-axis representing 1% fees) and if there were no fees, half would be above and half would be below. If you can get the market return, the typical active manager will be 1% less than the market. You're much more likely to be on the negative side of the distribution with active managers. But you can definitely try it.

I will also be writing about financial repression in the next edition (*GH comment: this is where the government interferes with free market operation*). I would not buy a bond index fund today.

GH: It's really interesting to hear that because if we focus on asset allocation rather than manager selection, how do you feel about the various investing models that are recommended to retail clients, say invest 70/30 and stick with that.

BM: There's no question that in my advice to the Princeton widows, they want to be able to draw some income out without having to sell all the time. They want to do it easily. I don't want them to get their income from a US bond portfolio, they should get it from emerging markets bonds where there's no financial repression, or in dividend growth stocks, which takes me back to a low volatility strategy. This is asset allocation, but I don't feel badly about doing it. If there's somebody in retirement who wants income, yes, I don't want them to buy Google and Facebook, I want them to buy a particular type of stock, but that's fine.

GH: And you also don't want them to buy a bond yielding 1%.

BM: Exactly, because I think they're going to get killed.

GH: So in that situation, the so-called lifecycle funds with an increasing allocation to the bond market …

BM: I don't like them, that's another thing going into the next edition. I've been a director of Vanguard, I'm on the Vanguard International board now, but I don't like lifecycle funds because at the end, they're putting 80% into precisely the securities that I think are going to give people an enormous amount of trouble.

GH: Let's turn to Wealthfront, which looks like it's gaining some good momentum.

BM: It's amazing. As I said in the panel discussion, I'm not sure about a lot of things, the only thing I'm absolutely sure about is that the lower the fee I pay, the more there'll be for me. So what we do at Wealthfront is we're using the lowest cost ETFs, we are also charging a wrap fee for doing the asset allocation of 25 basis points. So it's kind of 'Vanguardising', if you wish, the advice business. I have been with them since the end of 2012 and they've got $210 million of assets from almost nothing in that time. They are doing this using a lot of technology – we're not going to hold your hand, you can't do that for this price – and the marketing is done through e-invites, the clients are from places like Google and Facebook and Salesforce and they are happy to be serviced online. I don't think my Princeton widows would be comfortable with this approach, and if you want to pay more for advice, fine if there's someone who will hold your hand.

GH: I assume there's some process of risk assessment.

BM: Yes, we use some of the expertise from behavioural finance people, Meir Statman was one who helped us design the questionnaire so it's not simply age. That's too simple, people are all different. There are people for whom a very aggressive portfolio makes them sick to the stomach when it goes down.

GH: They can't sleep at night.

BM: More than that. They can't sleep at night, but one of the things we know about the mistakes people make is that they're more likely to sell when the market falls. They can't take any more. When people try to time the market, they usually get in at the top and get out at the bottom. You see it with mutual fund flows, you see it with pension funds. Are we doing it perfectly, probably not, this is not an easy thing to do. We have added people who know something about survey techniques, people who know behavioural finance, we get the questionnaire filled out and then we put people in particular buckets.

Just to give you an idea, I'm a client, and given my age, they had me in a safer portfolio than I wanted to be, and I said you can't just do it with age because I'm not investing for myself, I'm investing for my grandchildren. It's the horizon of the people you are investing for.

GH: Given your comments about low bond rates, if someone profiled as conservative, where do they go?

BM: As I said, the bonds we are using are bonds from countries not engaged in financial repression, have younger demographics, have reasonable interest rates, low debt and

better fiscal balance. I am the Chief Investment Officer and I design these things for exactly the reasons we discussed earlier.

Let me tell you the other things we can do. We do rebalancing with an automatic formula, and for taxable accounts, we do tax loss harvesting. Let's say you've got a US equity position, and the equity has gone down. We'll sell the Vanguard ETF and buy the Schwab ETF, it is essentially the same thing but it's not a wash sale when you do it that way, and take the tax loss, and particularly for the clients we have now, they can use the tax loss because their portfolios might be 98% in Facebook stock which they will be taxed on. This works well.

GH: One last question. You said recently, "We should be modest about what we actually know." Do you have any feeling of disappointment about progress we've made in investing. If I were a surgeon or a pianist, after 35 years, I'd be very good.

BM: I think the reason we have not made much progress is that it is probably one of the most overpaid professions there is. It's an inefficiency, with investment professionals paid regardless of the results. I've been an educator, and I just try my best in everything I do. I went to Wealthfront because I like the idea of doing good for humanity and I get paid in stock and I might do well financially at the same time. The real problem with us making enough progress in our industry is the misaligned incentives. But now, at least there's a lot of competition in ETFs and fees have been driven down to close to zero.

Harry Markowitz on investing until 100

6 June 2014

This discussion with Harry Markowitz took place at the Research Affiliates Advisory Panel Conference, Laguna Beach, California, 30 May 2014.

Markowitz's pioneering work on portfolio management was first conceived in 1950 and appeared as Portfolio Selection *in 1952. It proposed investors should act according to the expected return and risk along an efficient frontier, and became known as* Modern Portfolio Theory*. Markowitz won the Nobel Prize for Economic Sciences in 1990. He now divides his time between teaching and consulting, and he is co-founder of GuidedChoice, a managed account provider and investment adviser.*

The traffic between San Diego and Laguna Beach has been heavy all day, and Harry Markowitz is running a few minutes late for his meeting with me. I am about to meet one of the legends of the wealth management industry, and he starts by apologising for his long journey. He's nearly 87 years-of-age and no longer nimble on his feet, and yet it's soon apparent that the mind is as sharp as the young economist who studied with Milton Friedman. Every second sentence is still a wise crack. He's in the middle of writing four volumes on '*Risk-Return Analysis: the Theory and Practice of Rational Investing*', and is contracted to deliver the final volume in 2019, "So I have to live until at least then", he says.

Markowitz identifies the development of databases and ability to model expected outcomes as the major recent improvements in his portfolio construction work. Given a set of investments with forward-looking returns and defined risks, portfolio theory will show an efficient frontier for the investor. This principle has guided asset allocation and diversification for the 64 years since his original ideas. Says Markowitz, "I lit a small match to the kindling, then came the forest fire."

Markowitz tells me he has a wall in his office dominated by a cork board, and on it, a large graph shows returns over time from various asset classes. It shows $1 placed in small cap stocks in 1900 growing to $12,000, while the bond line has reached $150. I asked whether this shows that for anyone with a long-term investment horizon, their portfolio should be heavily dominated by equities, maybe even 100%. He said he is asked this asset allocation question all the time. His advice is different to a waitress in a coffee shop versus a well-informed investor with good professional advice. He tells the waitress to go 50/50, a mix of growth from a broad stock fund and security from bank deposits, because she cannot tolerate the volatility of a 100% equity portfolio. But an educated investor with good advice should take their current portfolio mix, find the most efficient frontier, then simulate possible future outcomes focusing on income expectations. The investor can then better judge whether the portfolio is the right mix to achieve the end goals.

Markowitz believes active stock selection is for a few highly skilled people who usually find returns not from stock-picking on the market, but by participation in private placements. He cites Warren Buffett and David Swensen (of Yale University) as consistently delivering excess returns but mainly because of the private deals they are offered and their ability to value them. Otherwise, outperformance is not worth chasing.

His own portfolio is currently equally weighted municipal bonds and equities, the latter with an emphasis on small caps and emerging markets, but with a stable core of blue chips. This is because he feels so many stocks are overvalued at the moment, and his portfolio is also influenced by his age. "I want enough bonds that if I die, and the equity market goes to zero, my wife will have enough capital and income to live well." His current objective is to reach 100 without appearing on the right-hand column of *The Wall Street Journal*, with the heading "Harry Markowitz f*cked up".

He is a great believer in rebalancing, and this is one reason why a cash reserve is always required. As equity markets rise, shares should be sold to retain the same proportional asset allocation mix. This provides a natural protection from overvalued stocks. He recalled working with a major Fortune 500 client in November 2008, after the rapid stock market fall,

allocating more to equities in a rebalancing exercise. This has subsequently paid off handsomely. But it was scary at the time, and as the market continued to fall, he thought if he keeps allocating more to equities at this rate, the whole place will be owned by him and Buffett. He likes the expression 'volatility capture' for this process, which is why there is a role for bonds as part of the reallocation mix.

I was still curious why a person with good savings at age of say 40, and strong income flows, would not invest 100% in equities, given their long term outperformance versus cash or banks. He said, "They may think their income is assured, but then may hit a rough patch and need to sell equities at the worst moment." He highlighted that many people have jobs which are also heavily exposed to the strength of the economy, and that they should also "diversify their own job and other income sources". He suggests investors should not become too smart, using leverage and unusual investments, and not try to become rich overnight.

He is also keen on using simulation to determine possible future outcomes. In his financial advice business, GuidedChoice, and especially in their new work on GuidedSpending, they ask clients to define an upper band of future income requirements, which might be say $50,000. Clients then define a 'scrape through' amount, such as $30,000. Simulations are done based on variables such as living longer and market returns "to capture the essence of the spending problem". Clients can vary scenarios to see the outcomes. The most common consequence of the process is that people save more, often dramatically and commonly 50% or more. While the technology behind the scenes is complex in this modelling, it is presented in ways the client can easily understand. But he dislikes mechanical rules such as taking 4% from the portfolio each year. "Why should someone who is 90 only take 4% if they want to spend more?" he says.

I ask him how a fund with investors aged from 16 to 90 should allocate its assets. "It's like a family," he responds. "There is a trade off in a family structure between paying for the education of the children, versus the future retirement of the parents. All families make these 'social choices', and so must the fund. Their decisions may not be ideal for the 16 year old or the 90 year old but everyone makes these choices in life".

And one of Markowitz's choices is to keep working as hard as ever. "I enjoy this, and what else would I do all day?" He now dedicates every Friday to writing to ensure he meets his deadlines, spends every Thursday afternoon at GuidedChoice where he consults to their institutional clients, and he maintains a heavy teaching and advising schedule. If his health allows it, he'll still be doing it when he's 100, and that right hand column of *The Wall Street Journal* will be singing his praises.

Elroy Dimson on investing, expectations and truth in numbers

13 June 2014

Elroy Dimson is a Finance Professor at Cambridge University, Professor Emeritus at the London Business School, Chairman of the FTSE Advisory Board and Chairman of the Strategy Council of the Norwegian Government Pension Fund. With his co-authors, he is the world's leading authority on the history of financial markets. His Global Investment Returns Yearbook, produced annually with Paul Marsh and Mike Staunton, gathers data across major asset classes for 25 countries (including Australia) over 114 years, and is often quoted as the definitive source of market information.

I met Elroy Dimson at the 2014 Research Affiliates Advisory Panel at Laguna Beach, California.

When Elroy Dimson presents a paper or consults to clients in New York, he tries to be back home in London the same or the next day, often without needing a hotel room. Some of his meetings with the Norwegian Pension Fund are held at Heathrow or Oslo Airport. He is acutely aware that his highest profile work, the Yearbook, is taking up more of his time each year. Dimson is one of those people who needs 25 hours in every day.

Real return expectations

The obvious question for someone who analyses thousands of data points across 25 countries each year is what should an investor learn from reading the Yearbook. For example, it reports that US equities have never delivered negative real returns in any 20-year period. Does this mean a long-term investor with a 30 to 40-year horizon should be invested almost all in equities?

Dimson does not encourage this view. He agrees that if you look at the statistics since 1900, the minimum holding period to be confident of a non-negative real return for US equities is 17 years. But the average for European countries is between 40 and 50 years, and he advises not to extrapolate from the past US experience, as the US may not be superior to most other countries in the future. Looking forward, with real bond rates around zero and an equity risk premium of maybe 3 to 3.5% and a 60/40 asset allocation, the overall return will be 2% real before fees. This is well under the expectations of most people.

He says expectations of returns have come down, and now many 'thinking people' believe a 3 to 4% real return is a more sustainable level for equities. By 'thinking people' he means consultants and asset managers who are honest with their clients, not worried that the client will think the consultant is failing to help achieve return objectives. Or that the next consultant or manager pitching 30 minutes later will be more optimistic and win the business.

Most investors need to accept and manage with these lower returns. Some endowments are supported by gifts, so maybe

it matters less for a higher education institution or a charity funded by a flag day, but others who have to exist on what they earn need to manage it very carefully.

Asset allocation and rebalancing

Dimson has strong views on so-called tactical asset allocation. He says there is no evidence that market timing works. But he is in favour of countercyclical investing, in other words, buying when the mass of investors need to sell. When equity markets have declined, for example, insurance companies are faced with solvency margin implications, which means they can't do their ordinary insurance business. If they don't have the right balance sheet, they are forced to sell their risky assets. It makes sense for longer term, long horizon, low liability funds to move in the other direction.

The most difficult part of a rebalancing, such as buying stocks when markets are still falling, is going against what most others are doing. Dimson says it's very important when buying on weakness and selling on strength to have a long term strategy that stops knee-jerking. He quotes a British insurance company which during a heavy market fall announced a strategy of buying cheap. They were loading up on equities as prices fell, but then had to reverse their actions to maintain their solvency margin. Likewise, family offices, institutional investors or sovereign wealth funds must be able to maintain the strategy, because the worst of all is to knee-jerk and end up in a big mess. The Norwegians don't fall into that trap because they have a disciplined approach to strategy.

The truth in the numbers

Dimson is most often referenced for his long term data work, but the Yearbook has become more than simply an accurate source of financial markets numbers:

“Occasionally we do venture into expressing strong opinions, but quite often, we try to let the data speak for itself. We don't make such strong statements as people who make a living from forecasting. Most frequently, we are listening to what we think are current concerns. We have to form a judgement by about September each year on what will be the hottest issue in February the following year, and then we do the research. We try to capture what many people believe, and we can then let the data confirm or reject the story.

“When it became clear that expected returns were lower, we wrote extensively about that. We also analysed historical data to see if equities might save you from low interest rates. History reveals that income oriented equity strategies have had a long-term total return that has been superior to growth oriented strategies. There, we were a bit more forceful.

“Some market beliefs are not well-founded. The work we did earlier this year on emerging markets addressed the belief that emerging markets outperform, but there’s no compelling evidence one way or the other. Some investors who follow our work closely have ended up having much the same percentage in emerging markets, Europe, North America, and the rest of the world.

“We’ve also looked at country rotation strategies. People have said if you’re invested internationally, you should avoid countries with weak currencies. You don’t want gains on a national stock market to be offset by weak currencies. But we find you get a higher long-term reward from the equity markets of countries that have experienced prior currency weakness.

“Some believed if you buy countries with strong economic growth, you’d be rewarded. We thought this was implausible, and our evidence is clear. If you buy the common stocks of countries that have low economic growth, the subsequent performance is on average better. The extra risk is rewarded.”

Financial markets commonly feed on urban myths and generalisations, but Dimson finds truth in the numbers. He likes nothing more than testing a market perception that has gained credibility, using long-term data to evaluate it – and quite often, to shoot it down. And then he’s off to track down someone who has the data on the 26th country to add to the investment return series, or to tweak the accuracy of last year’s numbers. It’s a project which will never end.

Robert Merton on retirement incomes and Jane Austen

7 November 2014

Graham Hand met Robert Merton at a lunch organised by the Australian School of Business’s Institute of Global Finance, based at the University of NSW, and supported by PwC and Finsia.

Nobel laureate Robert Merton is on a global crusade. At the moment, he’s travelling in Asia and Australia for the best part of a month, and after returning briefly to the United States, he’ll make his fifth trip for the year to Beijing. Around the world, governments and businesses are talking about pensions and retirement income.

In Australia, he’s arguing for a change in our superannuation thinking and culture. Although he recently turned 70 and was awarded the Nobel Prize for Economic Sciences in 1997, he still has boundless enthusiasm to make his case forcefully.

Even Jane Austen focussed on income

He’s almost indignant when he describes our fixation with accumulating a pot of money for retirement, rather than focussing on the income outcome. He likes nothing better than a platform to launch a tirade against the preoccupation with member fund balances, and to quote Elwood from The Blues Brothers movie, it’s like he’s on a ‘mission from God’. He says:

"The pile of money is the wrong measure. When someone wants to know how much a government pension is worth, they don't ask for the present value. They want to know the cash flow, the regular income. ExxonMobil tells you how much your pension is for life, not a lump sum. Even Jane Austen understood this. To show how wealthy Mr Darcy was (in Pride and Prejudice), she writes that he has an income of 10,000 pounds a year. She does not refer to his assets. Standard of living is a cash flow issue. Talking about the pot is the abnormal thing."

Merton believes this is far more than semantics. If you measure the wrong number, then you manage the wrong number. If a good standard of living in retirement is defined by a stream of income, it is unacceptable to expose a portfolio to market volatility that can upset that expected income.

Ideally, a good retirement amount should sustain the lifestyle enjoyed during the working life. It might have been acceptable to have $1 million invested in a term deposit at 5%, earning $50,000, but now in the United States, such deposits earn maybe 0.1%. The same client cannot live on only $1,000 a year. So having the $1 million pot was the wrong goal. And he adds, "If you think you don't need as much in retirement as when you're working, you're wrong."

An engineering problem with a solution

Merton is in Australia seeing institutional clients of Dimensional Fund Advisors, focussing on changing the conversation about retirement incomes. He's confident better solutions can be found.

"Retirement is a global challenge, but it's an engineering problem not a science problem. It's not like cold fusion, where we don't know whether the science can solve our energy needs. The good news is it's addressable. The retirement challenge is due to demographics, the ageing of the population, plus people are living longer. That's not a problem, it's a good thing. It's wonderful, but you have to do something about it."

He gives a simple example. In the past, you worked for 40 years and lived for a further 10 years after retirement. So you needed to pay for 50 years of consumption with 40 years of work. If you want the same standard of living throughout, then you must save 20% each year and consume 80%. It's simple mathematics (40 years at 20% gives 80% for the last 10 years).

What happens if you live another 10 years? You now have 40 years to save for 60 years of living, so you need to save 33% of your income and consume only 67% in your working years (40 years at 33% gives 67% for 20 years). Which means living longer requires a drop in your lifestyle from 80% of income to 67%.

This creates a problem:

"Most people are not interested in reducing their standard of living simply because they are living longer. Somehow, they want to maintain their standard of living by consuming more and then live longer, so what's the magic answer? Earn a higher rate of interest. That is easy because it means you do not need to do anything. But this is misleading and not feasible. What about the extra risk?"

He says that at this stage in the discussion, people often tell him that over the long term, the sharemarket will deliver the required returns to solve the dilemma. He points out that the market often goes a long time producing poor returns, citing a wealthy, politically-stable country like Japan where the Nikkei index peaked at 39,000 some 25 years ago, and is now at 17,000. Any solution needs to take responsibility for the advice if it does not work, and he adds:

"Embedded in most solutions to the longevity problem is additional risk, as if that solves the problem."

How do we 'move the needle' on the problem, other than working longer? There are only three possible sources of income for retirement:

1. Government, but funding problems make this an unlikely source

2. Employer savings plans, but 'defined benefit' schemes are no longer available

3. Personal savings. Where is the vast amount of wealth tied up for the majority of people, the millions of Australians heading for retirement without enough money? The only place is the family home.

The case for reverse mortgages

So Merton offers a surprising retirement income solution: reverse mortgages. He argues it can make a major contribution in most countries. The world has changed from where the family lived on a farm and the house needed to pass to the next generation to maintain the business. It is rare that a family home is a treasure that must be preserved for future generations. Children are unlikely to move back to the family home. In retirement, it's a financial asset.

Merton believes showing people how to use the family home to supplement income is an important part of a retirement plan. This may come as a surprise to an Australian audience, as reverse mortgages are not popular, with only about 40,000 in existence and many former providers stepping back from the market (both ANZ Bank and Bank of Queensland recently cancelled their products).

Perhaps it's a cultural issue, where we like to pass the full estate to our children, or the risk that comes from variable rate mortgages, where the debt can build quickly if rates rise.

To which Merton simply waves away the criticism. He said it's like listening to a song and not understanding the lyrics at first. After you listen carefully, at the twentieth time of hearing, you're singing along.

At the moment, in Australia on reverse mortgages, we're just hearing the melody, but eventually, we'll also understand the lyrics. Like in The Blues Brothers movie.

Kitces: How robo misunderstood the advice model and where to now

22 and 28 February 2018

Michael Kitces is recognised as the publisher of the #1 financial planning industry blog in the United States, based on awards and surveys. His website, kitces.com, is also home to the popular Nerd's Eye View. He speaks at 50-70 conferences a year, consults widely to financial planning groups, and is a Partner and Director of Wealth Management with Pinnacle Advisory Group (Washington DC).

I met with him in Sydney at the Portfolio Construction Forum's Finology Summit 2018, where he presented two keynote addresses including 'Robo-advisors are NOT the future (but technology is)'.

Part 1: How robo misunderstood the advice model

GH: Your writing highlights how standalone robo advice businesses have struggled in the US. Putting aside the potential of robo as a technology, do you see a future for a pure robo advice business model?

MK: Not much of one. My expectation in the US from the beginning when all these startups were proliferating was that one or two would survive, they would be the first to get to some level of economies of scale and they would be the brand leaders in the space. Ultimately, all they really are is an asset management company in the distribution business. Asset management distribution is highly competitive, it has horrific client acquisition costs and it's dominated by brand. So one or two could grow large enough to establish themselves, at least in a niche. And everybody else would die on the vine.

The robo advisers took financial advice job titles too literally. They figured what financial advisers do to create portfolios seems relatively simple, so we can replicate that for a fraction of the cost. They did not understand that the overwhelming majority of financial adviser compensations are commissions for product distribution. They are not actually paid for advice. They are paid for product distribution. And the robos brought an operational efficiency solution to a marketing problem. It was like bringing a knife to a gun fight … it doesn't go well.

During the dot com era, there were 100+ online brokerage platforms that tried to emerge. One or two independents were survivors, like etrade, the rest was dominated by incumbents such as Schwab and Ameritrade and Fidelity. I expect the same thing with robo, as I forecast from the start. One or two like Betterment or Wealthfront might at least survive, although I don't know that they will ever justify the valuations they have set.

All the rest are gone. When FutureAdvisor was bought, I said this is the highest price you will ever see for a private transaction for a robo adviser. BlackRock was willing to pay a premium for a first mover opportunity, but now they seem unable to capitalise. The gap is so far between B2C and what enterprises now need that even BlackRock has been leapfrogged by the second-coming players – the rise of what we're now calling Model Marketplaces – and now BlackRock is trying to push their funds through any technology company as a distribution channel. In theory, they bought FutureAdvisor so they did not have to do that, but they are pushing the others because FutureAdvisor did not work out as well as hoped.

GH: The other problem is that most robo advice offers in Australia are priced around 80 to 100 basis points, while many large incumbents are priced around 60 basis points (0.6%). Robos are not even achieving a fee structure like Wealthfront and Betterment have done at 15 to 25 points.

MK: It's a market-sizing thing. The dynamics for all these are: assume you've achieved scale then work backwards to your pricing. The hope is the VC funds bridge their funding needs between here and scale. The US market is deep enough that if you get that scale, you can justify that price point, but here the market is not as large. When they work backwards through the math, ironically you end up with companies that are less cost efficient than existing products.

GH: The other issue you write about is the Cost of Acquiring a Customer (CAC). Do you think startups completely misunderstand that?

MK: A few of them are learning it now watching the troubles of the others, but again, Betterment and Wealthfront thought the problem was the cost to deliver advice. It wasn't actually advice delivery. It was the cost to distribute asset management through advisers with commission compensation. Literally, the compensation was a distribution charge of the asset manager.

They didn't come to the table with a superior asset management distribution strategy, they came with a superior financial advice portfolio application system, which is not what the cost was and not what advisers were being paid for. We had put this 'adviser' label on our business cards and they took us at our word, that this was our primary value proposition.

GH: I look at the US robo offers and see the price point at 15 to 25 points, and would have expected a lot more success. Why is it at such low pricing that Betterment and Wealthfront have not done better? They are not startups anymore, they've been around for eight years.

MK: These are asset management distribution challenges. It's not 'If you build it, they will come." If price were the only determinant, why doesn't Vanguard have a 99% market share? As immense as they are, Vanguard's market share is

about 12%, which took 40 years of brand building. Investors are not hyper-rational, extremely efficient consumers who can identify the best deal, identify legitimate players from illegitimate ones, and then be willing to move.

Financial services is one of the lowest trust industries around the world, but we built something that should have been intuitively obvious in the lowest trust industry out there. People think a) it's a fake price and I'll be stung on the back end, or b) you can't possibly know what you're doing because nobody else is using it. It gets back to, "I don't trust the brand promise that your software is making." Building a high trust brand in a low trust industry is ludicrously expensive. It's not a technology problem. It's not a cost problem. It's an asset management distribution problem.

GH: Does the advice model need face-to-face contact to build trust, the 'warmth' discussed at this conference.

MK: The most trusted brand in the US is Amazon. All computers, no human contact. Can't even get a human if you want one. We don't have any problem learning to trust technology companies, because they are doing it by default in a trusted industry. Robo advisors try to frame themselves as tech companies, but they are managed accounts in the asset management business. Good luck scaling that fight for the brand.

Part 2: Where advice went wrong and where to now

To give some context before the interview: In Australia, the Future of Financial Advice (FoFA) reforms implemented in 2013 required financial advisers to act as fiduciaries and put the best interests of clients ahead of their own. The reforms also addressed conflicted remuneration and banned commissions paid to advisers by product manufacturers (such as asset managers). Similar legislation has yet to be passed in the US, and some of Michael Kitces comments should be viewed in this context.

However, in a report called 'Financial advice: vertically integrated institutions and conflicts of interest', issued in January 2018, ASIC reviewed the quality of personal advice in the largest licensees in the four major banks plus AMP. While the conclusions have been criticised by parts of the industry, ASIC found that clients were invested heavily in in-house products after receiving advice, and the quality of advice was often non-compliant, as shown in the graphic below.

We give this background to the interview with Michael because many financial advisers will argue that FoFA fixed the main problems, that much of the Australian advice industry has moved to fee-for-service, that advisers are leaving the large institutions and that his comments relate only to the US. ASIC's research suggests many of these issues remain relevant in Australia, although clearly many financial advice firms have adopted high standards.

GH: How do you see the changes brought on by the ban on financial advisers accepting 'conflicted remuneration' or commissions from fund managers?

MK: I wrote an article maybe five years ago with predictions on how the Australian market might play out under FoFA based on what we'd seen in the US. A major theme was the expansion towards more independent advisers and platforms because it's much less compelling for large vertically integrated firms to provide wealth services when they just get paid for the advice. They cannot be vertically product distribution channels any more. I hear now a few of the large firms are spinning off their wealth management businesses.

GH: Why can architects and lawyers charge $10,000 to do a job but most people will not pay a financial adviser such amounts?

MK: We're terrible as financial advisers at explaining our value proposition. We don't target well. Clients say, "What are you going to do for me?" We say, "I'll help you with whatever you need." That sale only works with people who think they are so incompetent at managing their own personal finances that they need an adviser. Most people have not become so destitute about their own competency that this is a valid value proposition. And then we make it worse with impossible brand promises.

Surveys in the US show there are two primary ways financial advisers differentiate themselves. Number 1, my ability to understand the needs of my clients. As if anyone would ever say they don't understand. Number 2, 72% said they differentiate on the breadth of my expertise. NOT the depth. So my marketing brand promise to clients is that I know more about everything than anyone else, which is not even believable. And it's not possible for 72% of advisers to be above average. The math doesn't work. We struggle to make any differentiating statements, they are barely table stakes.

When the product goes away and advisers have to sell the advice itself, they are still figuring out how to do that. The worst paid people in any knowledge profession are generalists. Specialists get paid more. That is the evolution we are making. For example, I know what a brain surgeon does. When I've got that problem, I'll pay a lot of money for that solution.

GH: So if you have an adviser client who has this communication problem, what do you tell them to do?

MK: Advice should be about deeper niches and specialisations. That's the evolution of the next 15 to 20 years. Down that road, you can market and differentiate more effectively. You can create more tangible advice outcomes relating to the exact type of people you are working with, and better client experiences. It's easier to do when all your clients are the same. You gain efficiencies because you don't need to look up new things about how to handle the next client. You become the leader and expert in that niche. You can sit across from people and give $500 an hour advice off the top of your head. Right now, you can't do that so you have to price in the time it takes to research, and the time it takes you to market and find clients because you're not recognised for any expertise.

GH: Why can I go into a Ford car dealer and accept that he will only sell me a Ford, and nobody questions that? But if I go into a financial adviser, and they sell me the in-house product of the vertically integrated wealth business, that is unacceptable.

MK: Because Ford does not market itself as a comprehensive automotive consultant. They are Ford car salesmen or women. I know what I'm going to get. Here's an analogy: if I go into a butcher's shop, they will sell me meat. Everybody understands that, they don't advertise themselves as dietary nutrition experts who happen to always sell meat. The problem is not the nature of the product sale. The problem is we've attached the label 'advice' to product sales. Technology is making it easy to sell products so we can't get paid for products. Now we get regulatory conflicts when sales people give advice. It's a global issue as countries define a fiduciary rule.

GH: What's wrong with saying, "I sell my own products, and they are high quality and competitive"? We simply accept it's sales, not advice.

MK: It's the label problem. If we said, "This is my annuity sales person, would you like to talk about our annuity product?" then all of these problems go away.

GH: So why don't we do that?

MK: Because advice sells better. You can sell more annuities or investment products or insurance or whatever proprietary thing you want under the guise of advice. The industry did their marketing studies and found when you put 'financial consultant' on the business card, people buy more. But the sales industry took it too far, consumers complained to the regulators, who said they will now regulate advice.

I would prefer not to see uniform fiduciary standards across financial services, I prefer a 'truth in advertising' control of titles that says 'sales person' on the business card. I know when I go to The Gap and they say the jeans look good on me, that they work on commission. I know how to judge that advice. We understate how knowledgeable consumers actually are about basic relationship dynamics like advice versus sales. The dilemma is that the regulators have come in and said if those are the titles you're going to use, we're going to regulate you.

Platinum's Kerr Neilson: it's all about the price

25 February 2018

Kerr Neilson, Managing Director of Platinum Asset Management, was interviewed by Vincent O'Neill, Director of Private Wealth at Stanford Brown, on 24 April 2015 at the Stanford Brown Quarterly Investor Insight luncheon.

VO: What makes a good investment manager?

KN: You need to have some idea about what you bring to the game. You wouldn't enter the Olympics without some 'edge', and it's the same in the investing business. You have to define your 'edge' to yourself. One 'edge' you could bring is that which others find difficult, such as thinking in a contrarian manner. There's a big problem with investments. Believe it or not, there's no specific price for any asset. Some good companies are now worth 10 times the amount they got down to in the GFC. They haven't become 10 times better companies. When you buy and sell in the stockmarket, you need to have a reference point against what other people think. Value can shift around massively. You need to be a contrarian to start looking for gaps. You need a way to distill out the confusion and noise.

VO: And what have you changed or learned over the years?

KN: Like all investors, you initially start looking for a bargain. But now we have the internet, it's completely transformational. It's as important as the railways and the automobile. On the one hand, you know what you'd pay for traditional companies, but then you've got this ginormous event which opens up the world to everyone. A company can be so much more valuable even though it started in a garage in Sydney. The value proposition is difficult to understand. With these changes, you need to change your own approach, at least at the margin.

VO: And you need a recognition that some are speculative.

KN: You need a high upside to justify the uncertainty and you need peripheral vision. A problem analysts have is that they

spend a lot of time on a company, and they feel they need to be rewarded for that time. They still want to buy it, but you can't do that if you're running money.

VO: In what conditions does Platinum underperform?

KN: The times we are least effective are the times like the last six years, where there is little dispersion of valuations, and huge trending. The herd is going in one direction. The one market you had to be in was the US, and we have been progressively moving out of it.

VO: Does that make it difficult for you, as people question your stance?

KN: You need to build a team slowly over a long period of time because you have to think differently. To keep people of that nature is not easy, it's a certain type of mentality.

VO: You're a keen student of history. Can you share some of the key lessons from the past, including any insights for the current conditions of extreme monetary policy.

KN: You don't need to be an historian, just start with the human condition. We are all slaves to our frailties, and we have little ability to suppress those animal instincts: fear, greed, jealousy, all these weaknesses we have. When you read the literature of the 1930's, we had all this discussion about when to tighten monetary policy, and then you had some very volatile markets. So you can find precedents in history, but you must always look for the differences. We have a big change which is globalisation, and it is more powerful now. We have a transfer of capital and technology, and a massive pool of labour in China and India that is priced at $100 a week rather than $100 an hour. You need to be careful because we'll have a lot of labour substitution which implies that growth in the West will be lower. The gap is so huge and the biggest problem we face is this arbitrage of labour costs. Through technology, you can quickly teach people how to do things, you can automate so much of this.

VO: Older people spend less on goods and services, they don't have babies or buy houses, while they have higher health costs. What do you think about the drag on global growth from changing demographics over coming decades?

KN: In my view, technology is more disruptive than the ageing of the population. And India and Indonesia have the opposite problem of millions of young people entering the labour force, what do they do? The challenge is expectations. We've had 24 years of growth in this country. We're not prepared to make these adjustments and it will come through the exchange rate. I don't think the exchange rate will drop right now, but our labour costs are making us uncompetitive, so there must be more reduction in the currency. Our expectations have to be reined in.

VO: Can you talk us through your views on China.

KN: China will grow slower and in our view, India will outpace it by a factor of two. China might go down to 4½% to 5%. It was spending $4 out of $10 on building for the future, capital works like bridges and roads. In China, the locals are switching from property to shares, at the same time superannuation and insurance is growing, so there is more of a market economy going into financial assets. We can still buy companies at reasonable prices but they've moved very quickly.

Here's a point I can never repeat often enough. This business is not about creativity and great dreaming. It's all about price. When the price of something has collapsed by two-thirds, as the Chinese stockmarket did until a year ago, that's not when you get worried. It's when it's gone up three-fold you should be worried. When it goes down you should be delighting in the prospect. Let me labour this point. If I offered you the car of your dreams, you'd be hounding me to tell you the price. I used to be in stockbroking, and as prices went up, our clients really lusted after shares as they became more expensive. But that's not what they'd do with their Mercedes Benz S-Class.

VO: You've had a lot of exposure to Japan, can we expect Japanese companies to be managed to deliver shareholder value better?

KN: This is a remarkably introverted country, but we are seeing clear evidence of the leading companies changing in the way they select directors and the focus on profit. They don't have bad returns on sales but they always over invest. They have such social cohesion that they'll all fall into line. The market's around 20,000 and it's likely to get to 25,000 and then get into trouble at 30,000 – I think it's got 50% to go over the next couple of years. When you have a currency that falls from 75 to 120, your cost competitiveness is spectacular.

VO:What are your views on the economic outlook for Europe?

KN: The central problem is the productivity gap between the north and the south. The south can't close the gap. There's no central exchequer, there's no backing of a central bank. I suspect somewhere down the line we will get into trouble again.

VO: Are you still happy to be overweight in shares and not too much in cash at the moment?

KN: It depends on your time frame. In 1939 if you owned shares in Deutschland and your cities were flattened and industrial base destroyed, it took until 1954 to get your money back. The same is true in Japan. The only places that you did not retrieve your wealth was in China and Russia because there was a regime change. So you're talking to a junkie here, we always see the benefit of shares because of the rewards over the long history. The trouble is, most of us go to water because we do not fully comprehend that it's the very essence of our living, our whole structure, to own these companies. To lose faith in equities, you have to believe there's a change in the entire structure. A fundamental change in the economic management of the system. So that's why we say it is volatile but it is the underpinnings of our living standards. Even in the worst of times, capital will migrate to the best business opportunities. It's a constant in our system, and to lose that, you must think we're going back to some form of central control and ownership.

Please take away from this one critical message. Price is critical. What does the price say? It's not about the headlines, it's what is in the price.

Interview with Sir Michael Hintze, AM: why an investing edge needs imagination

14 March 2018

Introduction: Sir Michael Hintze, AM is the Founder, Chief Executive and Senior Investment Officer of CQS, a London-based credit-focused global multi-strategy asset manager with AUD20 billion in funds under management as at March 2018. Sir Michael considers himself an Australian having come here as a refugee from China and receiving his education at the University of Sydney and University of NSW. In the charitable sector, The Hintze Family Charitable Foundation has provided funding to over 200 charities mainly in the UK and Australia. This exclusive interview with Sir Michael Hintze, AM took place on 8 March 2018.

GH: You've made the point that to have an investment edge, knowledge is not enough, you need imagination. How important is it when you hire staff that they have backgrounds and interests outside of finance?

MH: Over the years, I've hired staff with broad backgrounds, but let me say, they do need to be numerate as well, good with numbers. I've hired people who are historians or work in English literature, for example, many different backgrounds.

Knowledge has become a commodity, and true alpha lies in insight and imagination. You construct an investment, trade it and then risk manage it. You get paid for the imagination.

GH: When you interview someone, how do you find out if they have imagination?

MH: It's difficult, that's why you need to have a conversation. We have a process to see whether they can absorb some facts and how they think about them in a creative way. We might ask if they've seen something in the news today, what they think of it and have a conversation around it. It's hard but you can pick up if someone is not aware.

GH: You also write about the need for context and deep analysis in investing. Do you find you need to encourage staff to switch off their first reaction to something (what Daniel Kahneman calls 'System 1 thinking') and delve deeper into a problem?

MH: That's why you have processes. You want analysts who pull apart a problem, you want them to understand the fundamental issues around it with issues viewed through the lens of our models.

GH: Is that what you mean when you write, "Models are a great way to begin but a terrible place to end."?

MH: We have models which simulate various scenarios, but the really interesting thing for me is thinking about the problem and using imagination and judgement. We like to look at what can go wrong. For example, looking at the sub-prime market meltdown, you need imagination to say whether it will matter or not, to try to think about the fatter tails, the opportunities.

GH: In 2008, despite delivering excellent performance in the previous few years, your funds under management fell corresponding with a negative performance. And then 2009 and 2010 performance was again good. The same in 2015, there was a negative followed by a really strong year in 2016, but funds flowed out in 2015. Is that frustrating for you, that some investors take such a short-term perspective and exit at the wrong time?

MH: Operationally, we're always watching liquidity, we're watching what's happening, and perhaps that makes us an ATM. Many of our investors who were getting cash calls in 2008 needed to take money out.

GH: I can understand why you felt like an ATM around the GFC, but what about 2015?

MH: I think what happened in 2015 was a general view that the credit cycle was going to turn and the strategies I manage had substantial exposure to that. It's structured credit, and to some extent, still is. But we need to make sure our messages are put together in a more effective way.

GH: Your long-term track record is outstanding with only three small negative years since 2005. Do you look back on those years and ask what did we do then that was different?

MH: We always study where we make and lose our money, we pull it apart, I make sure we have liquidity and excess margin, we manage operational risk, and we take a longer-term view. The types of investments we make where the market falls often allows the next year to be much better.

In 2015 for example, there were a number of dislocations such as the end of QE, the end of the year concerns over China growth and systemic risk, a sharply-declining oil price, and that affected the high-yield bond market. That dislocation provided an opportunity to set up for a good 2016.

GH: It does look like many investors are exiting at the wrong time.

MH: I think they might but that's the nature of the business. I'm just managing strategies for long-term opportunities and not worrying about if it falls a bit.

GH: You've had an office in Sydney since 2010, and CQS funds are not available to retail investors although they are available to sophisticated investors through some private advisers. We have a shortage of the types of funds you manage for retail investors. Are there better opportunities to open access to retail investors in Australia, perhaps with a listed vehicle?

MH: We're uncomfortable with the potential volatility not only from the assets, but in a listed entity, the discount or premium relative to net asset value. It doubles up on the NAV volatility.

GH: In some of your presentations, the amount of detail on geopolitical issues is mind-boggling. How do you stay on top of it and lead to an investment decision?

MH: Again, we have a process, we have staff who do it and it's been my passion in my thinking, it's always been there. The market will also give a view, provided we've already done the background work. You start with noise, such as prices, news and events. You have to structure that noise into data sets to be able to create information and do more work on it to create knowledge. The problem is that because of education and data services, many can get to that knowledge, and there are lots of financial qualifications such as CFAs, CAIAs and MBAs.

Plus we're very well plugged in, we access think tanks. The key is to understand the transmission mechanism, not every interesting event will have a market impact. If you're in the Department of Defence or the Home Office or Foreign Affairs or wherever, you'll have a different take on it. Consider, say, the ebola virus versus SARS. Different cost and effect on GDP.

GH: Can you elaborate on your comments that social media undermines the battle for ideas?

MH: If somebody says something that is mildly controversial, the trolling can get quite aggressive. It doesn't even need to be controversial if you put your head above the parapet. It's not just the individual, it's their family. An example is my view on the environment. I care deeply about our planet and our environment is complex and fragile. For the record, I do think there is anthropogenic climate change and the whole global warming issue is important, but the almost-exclusive focus on CO2 is too simplistic. When I write that, I've had most horrific hate mail. The point I make is it's all very well to get the Government to focus on CO2, but what about deforestation, use of antibiotics, what about plastic pollution and poisoning the oceans, biodiversity, what about all those critical issues. Some people think all we should legislate about is CO2 and we'll be fine. We need a holistic view and strong global leadership to tackle the environmental challenges our planet faces. It's like the sugar debate … people should know not to eat too much and exercise more, why should the government legislate against sugar?

GH: Do you mean it's a personal responsibility, not the government's?

MH: Any market needs to have rules and guidelines but governments cannot simply legislate things away. We are living through a time of unprecedented challenge and change and the old world order is under threat. The institutions and governments and economic models we've grown up with are struggling and less effective. Politically-inspired regulation can be stifling. But given proper rules, markets, which are a voting system, can solve problems.

GH: Last question, it's important to mention your charity work, worsening income inequality, the plight of refugees, you say it's our job to protect the most fragile in society.

MH: Society cannot rely solely on the public purse. Prior to the 20th Century, it seldom did. I believe private philanthropy is better placed to motivate and partner with charities. We must take individual responsibility to look after others, it's our obligation to give back.

I often quote from the bible. It says, 'To those to whom much has been given, much is expected.' Charity is important. There are three principles that shape my philanthropy and career. The first is protection for the most fragile in society; the second is fostering aspiration; and the third is respect for institutions.

Pilar Gomez-Bravo: How to select assets in a world of choices

30 May 2018

Pilar Gomez-Bravo, CFA, is the Director of Fixed Income for Europe at MFS Investment Management. Pilar also has fixed income portfolio management responsibilities, having joined the firm in 2013. Prior to this, she was Managing Director at Imperial Capital and Head of Research and Portfolio Manager at Negentropy Capital within Matrix Asset Management. This discussion took place in Sydney on 15 May 2018.

GH: What's the first thing you check in the markets when you wake up each morning?

PGB: I manage global multi-sector portfolios, so there's a lot to cover. I check what interest rates have done overnight, what equity markets or equity futures are doing, movements in credit indices and key asset class relationships, plus the top news headlines. We construct portfolios from the top down but driven by bottom up research. We concentrate exposures on our high convictions, and we have to size exposures appropriately. We are running large issuer exposures and I check any developments that could impact them.

GH: When 10-year US Treasuries yielded 1% or less, how did you manage that and what do you think now is the argument for 10-year US Treasuries at 3%? Even with this higher rate, is there an investment case?

PGB: We have become a little immune to Quantitative Easing after 10 years of central bank intervention, but this level of liquidity injection was quite a shocking thing to do. It was an experiment and maybe there are not enough people around to remember what it was like to have central bank policy that didn't use such extraordinary measures.

The reason we had 1% rates in the US was because there were fears of deflation after the extremes of the global financial crisis, and uncertainty about how the financial system would recover. Australian banks didn't have the same degree of failure as elsewhere, but there was a lot of soul searching in markets that led to severe deflation fears in Europe and the US.

The central bank manipulation encouraged consumers and companies to spend money to recover from the shock. And that worked and now we are in a different period where we are seeing signs of inflation instead, but still not sufficiently high to worry people too much. There's a little bit of wages growth pressure in the US but nothing that indicates a sudden different paradigm of inflation.

Demographics, technology and debt will limit inflation rises

And in the back of investors' minds is the large structural headwinds against yields going higher such as demographics, the deflationary nature of technology and the amount of debt in the world. If they raise rates quickly, will consumers and companies be able to manage that increased debt load? There's also heightened sensitivity in the G20 about currency wars. So we should continue a gradual progress to higher global yields but at a pace that should be able to generate a long-term total return from fixed income.

GH: As in the US, in Australia we've seen a movement in what we call MySuper towards lifecycle (or target date) funds. What do you think of lifecycle funds and the merits of putting more into bonds as people get older?

PGB: Well, 20 years ago I took the CFA and back then we were already talking about the appropriate level of risk for different age cohorts. There's economic theory that says as people age, they have different risk return profiles. And it also shifts as people become spenders and stop earning. People are living longer and so the nature of the products they need should shift. On top of that, shocks like the financial crisis linger in the mentality of investors for a long time. Investors are reluctant to potentially lose all of their savings and they look to own some lower risk assets to protect capital by holding fixed income.

There is an increased variety of assets to invest in today than there were 20 or 30 years ago, so that gives more richness to the allocation decision for investors. For example, more ways to invest in real estate, a more targeted approach for individuals by using ETFs, or even shorting the market to take a negative view. All of that is relatively new which gives more ways to discuss the risk return profile.

Equity managers argue they can deliver income

A major development when yields went so low was that generically equity managers could go to clients and say they would be the providers of income and investors could forget about bonds. On this basis, the discussions from equity managers with company management led to dividend increases, and that's distorted the behaviour of companies around the world towards higher dividends, share buybacks and less investment. So perversely, central bank policy has led to lower levels of investment worldwide as companies have chosen to do share buybacks and dividends to appease their new shareholders with a promise of income. Hopefully, we'll see a gradual shift back to investing in the company as policy normalises and global growth stabilises.

Finally, now we can go back to saying that with bond rates rising, especially in the front end in the US, we have an asset that gives a yield and that is good for investors looking for safe assets.

GH: Can we discuss the move to passive investing in a bond context. Would you support the view that for non-government bonds, the case for passive investing is probably the weakest of any asset class? Is there evidence that retail investors understand why it's a weak argument?

PGB: There are a couple of reasons why it's more dangerous to follow passive investing in credit markets. One is that benchmarks are dominated by companies where the more debt they have, the bigger weighting in the index. Two, liquidity matters in credit and you may not be able to get out when you want to. That leads to another discussion around ETFs and derivatives. Credit markets become illiquid in periods of stress.

And three, in credit markets you have an asymmetry of risk and return. You have no upside and you have all the downside. So paying attention to potential blow-ups becomes increasingly important as the economy reaches the end of the cycle. A keen awareness of risk-adjusted returns is needed because you don't recover from a credit default.

The role of active management

People have forgotten about the value of active management. First, yields are low at the moment so any fees paid are painful. Second, with low volatility and low dispersion, it's difficult to generate alpha without adding leverage or taking concentrated risk, but with an asymmetric asset class and increases in volatility, the value of active becomes apparent. We tell clients when looking at active asset managers, ask them to show their excess performance in different periods of volatility. Obviously, you want to see performance through the cycle, but you should expect higher excess returns in periods of heightened volatility.

GH: With your own portfolios, how much of the extra returns you generate comes from off-market transactions? For example, where a company wants $500 million quickly and they ring you up and offer say 100bp over the market.

PGB: Our strategies have two characteristics for portfolio construction: liquidity and diversification. We don't hold a lot of illiquid positions and for those exposures we need to be paid more because you lock yourself in. In the hunt for yield, there are three main ways to add yield. One is duration, which nobody wants. Two is credit risk, so we've seen huge inflows into credit and emerging markets. And third is illiquidity. There may be better opportunities at times of stress to consider more of these off-the-run illiquid positions.

GH: What do you think about the big spread contraction in the high yield corporate sector? Is there adequate reward for risk there now?

PGB: At the individual level in some cases, yes, but at the lower quality parts of the high-yield market (rated CCC), you are not getting paid enough for the traditional experience of losses. Despite the stresses seen in equity markets, the CCCs have outperformed. They have lower rate sensitivity, when the fear in the fixed income markets has been that the Fed might make a policy mistake. There's also a lot of energy companies in there that have been supported by rising oil prices. In general, we believe that high yield as an asset class is expensive.

GH: It's difficult to make statements about correlations between asset classes in advance of a stress event. We saw during the GFC correlations rose so that when you thought there was protection in your portfolio, it didn't help much. Can you give guidance on what you think about future correlations? Is there anywhere safe to hide?

PGB: You are always looking for uncorrelated returns and good sources of alpha in multi-sector portfolios. The first choice is between duration and spread and the right combination, and that decision depends on what paradigm you think you are living in. For a long time back to the 90s, the paradigm was 'risk on, risk off'. But since the GFC, the new paradigm is 'Goldilocks/QE' and 'taper tantrum', where yields and credit perform in the same direction. I think as monetary policy normalises, we will revert to the 'risk on, risk off' relationships. It provides more of a diversifier against risky assets or spread assets. The reality is that in periods of stress, bank correlations move to 1.0, even though fundamentals have significantly improved since the GFC. When fear strikes in the markets, all banks underperform.

How to create a multi-asset portfolio

GH: What's your high-level process for creating a portfolio?

PGB: We are really mindful of risk management at every step of the investment process. First, decide how much risk you want to take, your risk budget. Then you have to do your allocation correctly. How many uncorrelated sources of alpha can you put in. Then you need portfolio construction where you match risk allocation with idea generation. What bonds do you actually want to buy that get you to that risk allocation? Finally, monitor the risks so that under any scenario, you don't get surprised by unwanted sources of risk. So that's still the basics.

GH: You probably know we had our Federal Budget recently. Conditions are better than expected with a possibility of moving into surplus next year. Now there's a debate on whether we should spend more, tax less or repay debt. What's your view on governments repaying debt to give more security for the good times, especially for the US where trillions in debt don't seem to matter?

PGB: At a basic view, whether you are a corporate or a government, you need to be countercyclical in your finances. You need to build cushions in the good times for when the bad times come, so you can then spend the money and keep growing.

There's too much debt in the world. The IMF forecasts that most countries will significantly reduce their debt-to-GDP ratios between 2018 and 2023, but the US will continue to increase. All the efforts of countries like Germany and Australia will be completely offset by the US as it's such a huge part of global GDP. The US has fiscal stimulus at a time of almost full employment when that extra stimulus is not necessary. So when times get rough, how much more can be borrowed?

Why an early roboadvisor pivoted away

7 November 2018

BigFuture launched its 'cloud-based wealth advice service' in 2015, driven by three experienced co-founders including Donald Hellyer. It raised capital and promoted itself at trade conventions, and produced an entertaining newsletter and educational videos. It was a runner-up in the 2015 Afiniation Showcase for the Best Robo-Advice service.

Three years later, it issued this advice:

"At the end of May 2018, we intend to close the BigFuture website. We are proud of what we built but regretfully we were unable to commercialise the application …

BigFuture Pty Ltd is still around as an entity. We are working on revenue producing projects."

This is my interview with Donald Hellyer, CEO of BigFuture.

GH: What was the original vision for BigFuture and how did it change over the years?

DH: It was quite simple. Most people don't have a good handle on what they own. They often have the 'spreadsheet from hell'. And a single number on the value of their assets in the future provided by a super fund calculator is bound to be wrong. It is deterministic and life is much more complicated. Nobody really cared enough do a better job, so three of us who had been working in financial services all our lives thought there was an opportunity.

We wanted to link up a person's entire financial position and give it real time to a financial planner, and it's something with even greater need now given the Royal Commission revelations on fee-for-no-service. How do you create better interaction between clients and advisers?

Think of three or four possible markets for a product like ours:

- B2C (business to consumer), a system used directly by investors
- B2B (business to business) with financial planners as one market, super funds in another, and possibly fund managers

The main lesson we learned along the way in B2C is 'verbs not nouns'. That is, we can give clients details, but we need to give them an action, something to do.

GH: Do you mean particularly in communications to them?

DH: You got to say, "Here are the results, now you can do something."

GH: When you first started, you were ambitious about B2C.

DH: Yes, we were, it seemed a logical space to be. Perhaps we were early. There's a problem that millennials don't have enough money and don't feel particularly engaged anyway. Most want to repay their student loans and save for a house. And not enough people with more money want to share their details on a cloud-based system. We did not create the required virtuous circle to keep building more functionality.

GH: What about the difficulties finding an audience, reaching out to people?

DH: It's chicken and egg. Any development must create something people want, not something that you think they want. Perhaps nobody knows what the 'market' wants. Everybody has ideas, and some of them will work among the thousands who try. I would not have thought that Acorns (now Raiz) would work, but it has, with relatively low marketing expenditure.

The age of 65 is never going to occur for a 30-year-old. Raiz has made a fundamental change in the business of super compared with institutions, allowing people to put $1 in super when they buy something. It links spending with long-term savings.

When we started BigFuture, I joined 15 super funds to check the experience, and only two called me after I signed up. If you're a millennial, you want better communication.

GH: Tell me more about B2C problems.

DH: We tried blogs and animations and social media but we never had a breakthrough. Maybe we should have started with an app not a website. But on an app, you struggle giving enough detail on a small screen. Maybe we just didn't produce something people wanted in enough numbers. Many people loved the product, but just because I think people 'should' know about their financial affairs, doesn't mean people will. We thought people would pay say $10 a month for the service.

GH: What was the point where you said this B2C is not worth doing?

DH: Well, we really moved in parallel, but we needed to work B2B with people who already had clients. We went to super funds who would pay us to offer the product to their clients.

GH: It seems like a strong proposition to a super fund, to offer your service to their members. You had some success, but why did it not resonate more?

DH: The game's not over, we're still working with the big funds, but we've 'pivoted' the business to make more money elsewhere. We put resources where the revenue is, into software development and coding.

Competition between the industry funds is minimal, they each have their constituent, there's no 'creative destruction'. Nobody is going out of business. The average person cannot distinguish between them, just like the top three electricity

suppliers. The effort required to differentiate the products is too much. It's not whether super funds care enough about the technology – it's about how fundamental it is to their business. The largest super funds will probably supply essentially the same services in five to 10 years' time as they do now. Smaller funds will be more entrepreneurial, they will want to add more value.

GH: What is your pitch to them? They should want what you're doing for their members.

DH: We only had good conversations, but they required all the development to occur outside the super funds and be proven outside the super funds. But people like us have the least amount of capital to do the development. Someone will break through but take the example of the listed company Decimal. Latest share price 1.5 cents.

The main business development of a super fund is not with its members, it's with the employer base that uses it. It's about becoming the default member fund.

You also have administrators in an oligopoly, Link and Mercer. So if you're going to do something special in technology as a super fund, how do you get the data? Neither has open APIs.

We have a couple of super fund clients with apps we have developed for them, with enhancements specific to the needs of their clients, rather than using the entire BigFuture picture we started with.

Other pivoting developments in the charity space include our launch of 'Charity Booster', an app designed to increase a charity's donor numbers. For example, donors can give to a conservation charity each time they buy petrol, or a charity like OzHarvest each time they go to the supermarket. We can deliver the whole thing for $30,000.

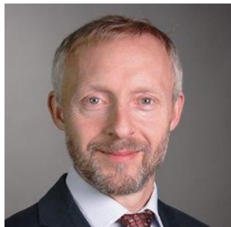
So instead of wealth aggregation tools, we pivoted into contribution planning through payments systems, plus the charity applications.

Fintech is a game of attrition. When does the business stop burning cash as it is creating something? I've got five developers cutting code, but if you're waiting for someone to make a decision, that's a major operating cost. Our expenditure goes on developing product and the cost of data. You need to find a toe hold where you can make money.

Barnaby Wiener on preserving wealth and asset allocation

28 March 2019

Barnaby Wiener oversees the MFS Prudent Capital Fund in London, which targets total returns over cycles by investing in a wide range of diversified assets. He has been at MFS for 21 years and is a former Captain in the British Army. Graham met with Barnaby on 20 March 2019 and this is an edited version of their discussion.



GH: You talk about the continuous balance between wealth preservation and wealth creation. Where are you at the moment?

BW: We're at the extreme end of wealth preservation, as our book is currently positioned as defensively as it could be. It's driven by our assessment of the opportunities arising from the risk and return opportunity available to us. And that is driven by a combination of valuation and an assessment of fundamentals, both at a micro and macro level.

Right now, generally, equities are risky relative to their history, and at a macro level, there are huge imbalances that have developed over a period of decades. It seems inevitable that until we actually address those imbalances, the system will become ever more fragile.

At the micro level, we see so many sources of disruption and threat for individual business models, partly driven by new technology. It makes it a challenge to find companies we have real faith in with respect to the durability of their cash flows and business model.

GH: Why do you place such importance on the 'principal versus agent' problem? It features at the start of your investment beliefs.

BW: The only person that matters is the principal when it comes to the investment. We're all operating on behalf of a principal, whether it's a wealthy family, or an individual with a retirement plan. There are so many layers of intermediation in our industry. Someone who's directly charged with the responsibility of managing money must have the mindset of what's in the interest of principal, the owner of the money.

The background to its prominence was my frustration with the constraints of traditional relative return investing and being measured against the benchmark.

GH: You have list of attributes that you look for in a company, but you admit that no company meets all these criteria. And there's no algorithm that allows for a trade off. With great companies such as Apple and Facebook, how does your investment process balance the risks? For example, the risk of regulation for Facebook, the risk that the next iPhone model might fall behind Samsung.

BW: We all struggle with it. It's fascinating that I can have conversations with colleagues looking at the same business through a similar lens but still coming out with a different conclusion. From our perspective, we've never been able to get comfortable with the sustainability of the Apple franchise, partly because it is so dependent on the next product. The value proposition means Apple products are extremely expensive. Yet I know the extent to which people are willing to

sacrifice a huge percentage of their income on an Apple product.

We believe Facebook is inherently a more durable business model than Apple, because of the extraordinary platform as well as Instagram. There are negative aspects but I think people are locked in. It's an extraordinary tool for connecting with people and for advertisers to reach that target audience. For particularly small companies who don't have the means to advertise on traditional media like TV or billboards, Facebook and Google have given them a route to market that didn't exist before.

There are obviously concerns about how the internet is regulated, not just Facebook. We're being paid to take the risk, but nothing is ever clear cut.

We try to be disciplined and rational in our approach, but all decision making involves an element of gut instinct and emotion.

GH: You say that all equity investing has an element of guesswork, and yet valuation is your primary investment tool. How do you reconcile those positions?

BW: Actually, we spend much more time focusing on our assessment of the durability of the business, because there are lots of companies trading on optically-cheap valuations which we don’t go near, such as banks and energy companies or companies that have challenged business models. Valuing bonds is a pretty exact science but valuing equities is not, because you don't own any right to the cash flow. So ultimately, we take a holistic approach, with a focus on sustainability.

GH: Some prominent fund managers place great emphasis on calculating the intrinsic value of a company, but you think DCF (discounted cash flow) analysis is too much guesswork.

BW: The financial world in general has become enslaved to the Excel spreadsheet, and I don't think that is ultimately healthy. Most of the things that really matter can’t be measured in a cell in a spreadsheet. One example is corporate culture. I think it is one of the biggest indicators of long-term success in a business. You can’t quantify that but you know when you see it.

This is a job that involves subjective judgment, with an overlay of a rigorous approach of questioning. But ultimately, we make judgment calls.

GH: All fund managers say they think long term, but they face pressures to perform in the short term. Where is the biggest challenge to long-term thinking strongest? Is it from your clients, your own self-esteem, or from your company expecting you to perform well?

BW: I don't feel it's a significant challenge with clients. We've been clear about our approach and that there's a risk that we will be defensively positioned as the market goes up. I think clients understand what we're doing. They're not buying the strategy purely as an equity strategy, the volatility is much lower and our peer group is multi asset.

The internal incentive structure is designed to reward the longer term, and it helps to have been at the firm for over 20 years. The biggest pressure is probably self esteem. I can't completely detach myself and say it's just an academic exercise. I would like to get it right. It's frustrating when a strategy is wrong for a while.

GH: Also in your guiding principles, you talk about the need to know your own weaknesses. Are you talking at a personal level or a company weakness?

BW: It’s more about being aware of personal biases. One's biases can be a good thing, but you need to be conscious of one's self knowledge.

GH: For many of our readers, the biggest challenge is the asset allocation piece, deciding how much to have in each asset class. What guidance do you have for someone with say a million dollars to finance their retirement?

BW: Firstly, what is their timeframe? The shorter the timeframe, the more liquidity they need. It also depends on the valuation of financial markets. If they buy into equities at peak multiples, they can take a long time to retrieve losses. Understanding the mathematics of compounding is also really important. If they lose half their money, they have double it to get back to the start.

You could say just invest and leave it there, and that's true in theory. But we can't divorce ourselves from our emotional response, and who's really willing to endure that kind of market volatility. It's all very well say, you got a million dollars fully invested, and in a bear market, it goes to $400,000, that’s alright because we're at the bottom of the market. The reality is, you're sitting there thinking, I've lost over half my money.

I think people should err on the side of conservatism, but that doesn't mean be fully in cash. Our investment strategy is trying to manage that on behalf of the end client. It's designed to give people peace of mind.

GH: What major insight does your experience as a Captain in the British Army bring to your investing?

BW: I think it’s a broader perspective on life. The financial world can be in a bubble of its own making. There are many aspects beyond investing that show what one’s values are. I think some people get wrapped up in the trauma of investment decisions, and it helps to be somewhat detached. The army was a very different experience to the one I'm in now.

Phil King on the long and short of investing

10 April 2019

Phil King is the Chief Investment Officer at Regal Funds Management and is responsible for portfolio management. Regal was founded in 2004 and manages alternative investment strategies with a focus on absolute returns from both long and short investing. Regal's Australian Long Short Equity Fund launched in 2009 with the strategy made available to retail investors in 2011. Regal has been named Australian Hedge Fund of the Year three times.

Technical note: 'Shorting' is the sale of a stock that the seller has borrowed from another party.

GH: I'd like to focus on 'long short' investing because that differentiates Regal. What's the skill difference in going long, which most equity managers do, versus going short, which few do?

PK: The main difference between longs and shorts is the fact when a short goes wrong, the problem gets bigger. When a long position goes wrong, the problem gets smaller. Some managers are good at investing on the long side and then they become traders on the shorts. And that doesn't always work well. I think you're either an investor or a trader.

We are investors on the long side but also investors on the short side. We take a longer-term perspective and we're valuation driven. We follow a similar investment process but the main difference between how we treat our shorts versus our longs is in risk management.

GH: And in theory there is potential for unlimited losses on shorts.

PK: Stocks never actually go to infinity but yes, you have to risk manage your shorts very differently. There are times when you have to reduce positions because they are going against you. Sizing is important and you should size your shorts a little smaller.

GH: Is there a difference in the time frame? Would you tend to keep your longs for longer than your shorts?

PK: I think that's a bit of a misconception. We're successful because we're happy to take a longer-term perspective on both longs and shorts. We have held many shorts for five to 10 years. I don't usually feel comfortable talking about my shorts, but there are certain manufacturing companies for example that we have been short for 10 years. They face such structural headwinds in Australia that you can't really see how they can succeed.

GH: So although it's a short, is a long-term view on the merits of that business.

PK: Yes, but you can't expect to make great profits on your shorts in a raging bull market. Anyone that's trying to make absolute profits in a strong bull market will be disappointed. Bull markets generally mean everything goes up, although there are always stocks that fall. That's why there's this misconception that you need to trade your shorts more aggressively.

We view our short book as insurance although we generate alpha (*Ed. outperformance*) on the short book. We run a long book as well and we don't have to worry about what the stock market is doing. We don't worry about tweets coming out of Washington or the Chinese economy. We focus on what we're good at and that's stock picking rather than all the macro factors.

Even the best stock picker who's long only generates most of their returns over time from the market going up. But in our market neutral fund, we generate all our returns from stock picking. We generate around 4% to 5% alpha from the long side but twice as much alpha on the short side because it's less competitive. Anyone can buy shares before they sell them but it's only a small minority of investors that can actually sell shares before they buy them.

GH: But one of your main funds is the 130/30 fund *(Ed. 130% long, 30% short),* so that faces the same influences as 100% long. You have the same overall market exposure.

PK: Yes, and the 130/30 takes advantage of the fact the market goes up over time. Since inception around half of the returns have come from market beta *(Ed. the level in the overall market)* and about half has come from alpha. We generate returns from the market going up but we also run the short book to give the opportunity to generate more alpha than a typical long-only investor.

GH: What are the constraints on your shorting capacity?

PK: As I said, position sizing and risk management in case things go wrong. Shorts are smaller and ideally more liquid than longs. So there is a natural constraint. We have one of the largest short books in Australia, short a billion dollars of Australian stocks, and we think we can double that. But we probably wouldn't want to get much bigger because of the liquidity needed when things go wrong.

GH: How are dividends on your funds affected by your short book?

PK: On a stock that pays a dividend, the share price normally drops by the amount of the dividend. So we have to pay away to the lender the dividend on borrowed stock but we usually capture it in the company's share price. We pass through franked dividends on our long positions to our investors.

We generally borrow stock from international shareholders and therefore we only pay them the cash amount of the dividend and not the franking credits as well. The investors that we borrow shares from are usually index funds and large institutions based offshore. Occasionally, if we're very bearish on a stock and sometimes all the foreign capacity is utilised, we do use domestic stock. Then we make a judgment call

about the timing of any dividends and whether the stock price justifies paying the extra franking credit on a dividend.

GH: How do you feel about the term 'hedge fund'? Do you think it compromises some of your marketing?

PK: There is a misconception about hedge funds in some minds. I think that's unfortunate because we are trying to provide attractive returns uncorrelated with the markets. It's simply trying to buy the cheap stocks and short the expensive stocks. It's all about valuation.

Often when we are shorting expensive stocks, we have a lot of respect for both the business and the management. It's not a reflection on the quality of the company, it's a view on valuation and people misinterpret why we're short.

Some people think hedge funds push stocks down and manipulate share prices. I think that's very rare and it's not certainly something we would ever do. In fact, I think there's more share price manipulation (as I call it) on the long side and more people talking things up than talking things down. There are more participants in that market with more to gain.

There have been some well-publicised short reports over the last few years by both international and local managers. This is a welcome trend. People should be allowed to express views and not get criticised for having a different view. Too often, the broker research is just cheerleading for the company. There are too many cheerleaders in the market and it's good to have true independent research.

Where we feel a bit uncomfortable is where some of the research becomes personal and we have the philosophy that we want to play the ball not the man.

GH: So the reputation that shorting has, such as during the GFC when some types of shorting were banned, such actions discourage liquidity in the market?

PK: The experience in the GFC told us that banning shorting doesn't help stock prices. They continued to fall after shorting was banned and it was not the hedge funds pushing stocks down. It was more the circumstances at the time and the lack of confidence and the fact that financial markets were closed in some areas.

Hedge funds which are short a stock are often the investors who can cornerstone a capital raising. They can provide finance to allow a company to survive. Sometimes, we find management is the last to admit they have a problem and need to raise equity. They must accept the truth.

GH: I was looking at your long short fund over the last five years. 2015 up 21%, 2016 down 6%, 2017 up 18%, 2018 down 6%, then in 2019, Jan and Feb up 17%. Strong results but up well one year and down a little the next. Are there any common characteristics in the up and down years, or do you sometimes give a bit back after strong performance?

PK: Two points. Firstly, we carry the same market risk in this fund as long only investors with exposure typically around 100%. So, some of the weak years coincide with weak years in the market. For example, in 2018 the ASX200 was down 7% and this Fund was down 6%. Secondly, we are what some people call a 'double alpha' fund because we generate returns from both the short side and the long side. Sometimes, alpha is hard to find and we look like a typical long only manager. And then there are periods where alpha can be realised and we do well.

GH: Can we finish up with some questions around the listed vehicle you planned for a few months ago? What was the reason for not doing it at the time?

PK: We are experienced enough to know that it's always harder to do a new issue when the market is falling, although we plan to have a LIT that we hope will perform well in all environments. It's harder to ask investors to write a cheque when the market is weak such as in the December quarter. It's all systems go now and we expect to lodge a PDS in April and go on the road, with a listing planned for June.

GH: Do you expect any differences in the way you manage the listed versus the unlisted funds?

PK: The main thing we will do differently is to have a diverse portfolio of some of our strategies in one LIT. We realise that some of our unitholders will be retail investors and we want to reduce the volatility of returns. We think we can build a diversified portfolio and a lot of our strategies are not highly correlated with each other. We hope to provide a compelling product for Australians who have too much property and equity exposure in their portfolios.

GH: So it will not simply replicate the unlisted retail 130/30 fund?

PK: No, in fact, it will be cornerstoned by our market neutral strategy which has low correlation with the equity market, plus we'll include our emerging and small companies strategies which I personally think are exposed to exciting parts of the Australian market at the moment with good earnings growth.

People have been knocking on our door for many years to encourage us to list a vehicle and I've been reluctant to pull the trigger unless we could do it well. We only wanted to go down this route once we had the team in place.

GH: How you got your head around some of the structural issues that LITs face, such as drifting into a discount which disenfranchises some investors? Even going into a premium can be a problem as people buy expensive shares and drift back to NTA.

PK: That's true and we would prefer not to see a lot of volatility in the discount and the premium. We will have the ability to implement a buyback if it trades at a discount for a significant period of time. We will be judged on the quality of our returns but also the discount or the premium our stock trades at verse the NTA and we're very focused on those two factors.

GH: Finally, when I've heard you talk, you use a lot of sporting analogies. What's behind that?

PK: I've got three kids very involved in sport and I spend a lot of time watching them play soccer and basketball and surf. I love all sports actually, playing and watching, and having a family with three kids keeps me busy on weekends.

Sebastian Evans: hanging on until the market catches up

1 May 2019

Sebastian Evans is Chief Investment Officer and Managing Director of NAOS Asset Management. NAOS manages three listed investment companies (LICs) with concentrated exposures to Australian listed industrial companies outside of the ASX-50. The LICs are in micro-cap stocks (ASX:NCC), small caps (ASX:NSC) and mid-caps (ASX:NAC).

GH: In the micro investing universe with more than 1,000 companies on the ASX, where do you even start to look?

SE: Sometimes we are criticised for having too few positions but we have strong company screens. We use ESG checks and we don't invest in resources, oil and gas companies, exploration companies and anything smaller than $10 million in market cap. That rules out most companies.

Then by the time we meet credible managers who can deliver on expectations and run public companies under pressure and meet goals and objectives, we're quickly down to about 50.

GH: Do you meet the management of every company before you invest?

SE: Yes. In some of our investments, we might own 25% of a company, so we're intimate with them - board, directors, senior executives, unlisted competitors, ex-employees … all the war stories. That's where I spend most of my time, with the investments. We're not traders, we've had some investments for seven years, which is essentially the length of our business.

GH: Given that management have continuous disclosure obligations, what sort of things do you get from them?

SE: The biggest is consistency of the message and that they deliver what they say they're going to do. In small businesses, as soon as something's not consistent or the messaging becomes loose, it tends to show there's something a little wrong. And then it can become seriously wrong quickly.

GH: Are you looking more at the person or the business or both?

SE: I learned the hard way that backing people in small business is almost everything. Good people are driven, they can manage teams, they have to run a listed company, and there are few people who can do all that well.

But if you invest in an industry that's struggling, you're not doing yourself any favours. You want to operate in an industry that has growth prospects today and for 30 or 40 years.

GH: After the success of growth stocks versus value in the last five years, do you feel the decision to restrict to industrial stocks has limited your performance?

SE: From an investment and performance point of view, it's definitely hurt. But from a company brand and business point of view, it hasn't hurt as we're consistent with our messaging. We're very transparent, people understand what we invest in. Sometimes, the best managers in the world go through periods where they are in the lowest quartile of performance. And unfortunately, although I don't look at tables, I'm sure we're in the bottom quartile in the past 12 months. Would I change it? No, because it's what we feel comfortable with and the team has invested in. There's no point in me managing other people's money and trying to invest in businesses that I can't understand and don't feel comfortable with.

GH: Why have you chosen the LIC structure, given it's a double-edged sword? You raise committed capital but you have to manage problems such as trading at a discount.

SE: We used to run two small managed funds, but we'd spend a lot of time on ratings, getting on platforms, generating advice demand. You know, all the conflicted gatekeepers. The real growth was never going to happen. We were the first LIC to list after the success of MFF (Magellan) but of course the market has come a long way since then.

Using the LIC structure was the smartest thing we did in the Australian micro-cap sector. I heard a prominent fund manager interviewed last week about his unlisted fund and he said, “Never invest in illiquid stocks.”

GH: Because of redemptions, which force you to sell.

SE: Yes, and you can't recover your losses. If something goes wrong, the fund can kill you. We take a very different view. We operate in a LIC format. We don't suffer from redemptions and we can invest in illiquid businesses that might be better than liquid businesses. Often it's illiquid because the founder has a large stake. The benefit of a LIC is you're not forced out of some of these businesses today. You can wait for them to become successful businesses.

GH: In the micro space, do you find sometimes you're the only professional analyst?

SE: Yes, sometimes we're the only fund manager on the register. If look at all the positions in our micro-cap fund, there might be two that are covered by brokers with one or two other fund managers there.

GH: And you see that as a comparative advantage?

SE: I do, but people will have their own views. I can get on my mobile phone now and I could call any managing director of stocks we own and they would pick up and talk for an hour and a half about the business. I could ask them for referrals from customers, old employees, whatever. We might not make money on them in the first six months, or even the first 12 months, but I feel we benefit from that level of understanding. A lot of bigger fund managers don't waste their time on a $10 million investment.

For example, we have a big position in a company called MNF Group. It's a voice-over-internet telco capped at about $300 million, where the founder owns 40%. Also, Lifestyle Communities, a retirement village operator capped at $500 million. We understand these businesses, especially when some of them are unloved.

GH: We've talked about the upside of the LIC structure. What about managing the downside? Most LICs trade at a discount to NTA, and a couple of yours are at decent discounts.

SE: Yes, it's frustrating. The LIC that we acquired (*Ed, now ASX:NSC, formerly Contango Microcap Limited*) was a lot harder than I thought it was going to be, as it trades at a big discount. When a LIC doesn't perform, it can fall out of favour quickly, and that's had more sellers than buyers. But I believe if you pay a good dividend, it puts a floor under your share price as long as you've got the reserves for the dividend. Our dividends have gone up every year for seven years.

NAOS spends a lot of time and money on messaging and marketing, even though we're not a profitable business. Our biggest investors are in places like Rockhampton and Adelaide, not Sydney or Melbourne, so for us to find the people who actually invest in LICs is very time-consuming. It's about developing their relationship with us as their fund manager.

GH: It's difficult for anyone to corral SMSFs, with 1.1 million trustees who are hard to identify and pin down.

SE: Exactly. It's a borderline nightmare. You need to find advisers who are not aligned or pitch to individuals on why we can invest in a market better than someone else. While in our space, there's not a huge amount of competition but our performance has been poor. The key is consistency of message but it's definitely not a get-rich-quick scheme.

GH: Given the size of your dividends, are you surprised it hasn't led to more support? Many claim retirees are interested in income and not overly fussed about what's happening with the share price.

SE: I don't think there's a lot of new money coming into equity LICs at the moment due to the uncertainty about franked dividends. They're looking for debt funds and offshore funds. NSC is the one we acquired (*Ed, current discount to NTA 20%*) with 6,000 shareholders, and we added 900 new ones to that but we lost 1,900.

GH: Would you like to name a stock in each of your funds that you're most confident about?

SE: In NAC, our biggest holding is MNF Group, and a lot of products offered by companies like Google and Facebook are voice-over-internet. Uber and Carsales use MNF. In NSC, we like another telco called Over The Wire. It's a one-stop-shop for telecommunication services, cloud services, security services, things like that. And finally, a small one in NCC is a business called Wingarra. They export oaten hay and red meat to China and other places in Asia.

GH: Okay, to finish up, what skill are you most proud of that makes NAOS a better fund manager?

SE: Being able to stick to what we have always said we will do. I've been doing this for 11 years and it's getting harder. Look at all the fund managers that have closed recently, and the competition from ETFs and index funds. I appreciate you've got to understand when something's not going right and you need to adapt to the times. But I think you need to stick to your core philosophy and we've been able to do that. And hopefully, it'll bear fruit at some stage.

Joe Magyer on pricing power, customer loyalty and the network effect

8 May 2019

Joe Magyer is Chief Investment Officer of Lakehouse Capital, and Portfolio Manager of two unlisted funds, the Lakehouse Small Companies Fund and the Lakehouse Global Growth Fund. Much of this discussion relates to the Small Companies Fund which invests in small, fast-growing companies in Australia and New Zealand.

GH: One of the main characteristics you look for in a company is pricing power. How do you identify it and convince yourself that it's enduring rather than short term?

JM: On the analytical side, we want businesses with high and stable gross margins, and if they don't have that, then odds are they don't have pricing power. The tricky part is going beyond that. Businesses that have exceptional pricing power usually don't come out and say it bluntly. They don't want regulators and competitors to know and they don't want to upset customers. So you have to piece it together. We also look at results relative to volumes and what competitors are doing.

It's not hard to raise prices during an economic expansion. But we saw some businesses in the US that prided themselves on CPI plus price increases for six or seven years and then they gave it all back during the last recession. Anytime you see that, that's a big turnoff.

GH: And you focus on brand loyalty. How do you test or verify that?

JM: That's one of my big, personal fascinations. Most investors chronically underestimate the value of extremely loyal customers. It's partly because they're so rare, and partly because in Australia, so many investors cut their teeth on mining and retail banking, neither of which are known for extreme loyalty.

GH: Banks tend to take advantage of existing customers and chase the new ones.

JM: Yes. John Mackey, who's the founder of Whole Foods and on our parent company Board of Directors, told me if you treat your customers like an annuity, you open yourself up to disruption. It doesn't mean that they're going to run away but you put a target on your back. So that's why we focus on loyalty rather than just switching costs.

Let's say you've got two businesses, one with 90% retention and another with 80%. Optically, that's not a big difference. In practice, the one with 90% retention has an average customer life of a decade, and the other is five years. So the business at 90% can spend twice as much to acquire customers, which is a huge strategic advantage. Or they can pay the same amount and get double the margin per customer. Either way, it's a far superior business and much more stable.

GH: And what's the difference between loyalty and switching costs?

JM: Switching costs make it a headache for businesses to move on, and while that's valuable in terms of keeping customers, we much prefer to see loyalty based on products and services that delight the user. Instead of just seeing, say, 90% retention, which is still great, we find revenue retention that's above 100%. Customers are so delighted that they expand their spend. For example, more than half the customers that use Atlassian are like that, it's a product that people love that's hyper scalable.

GH: What's the best example of pricing power, retention and loyalty you have seen in an ASX-listed company? One that even surprised you, maybe after you've invested?

JM: Altium (ASX:ALU) has been a phenomenal success story that not a lot of people pay attention to. And I think it's because their core product is not very accessible to everyday people. It's software for designing printed circuit boards, not something any of us are likely to be using. But over the past several years, they consistently raised prices with rising retention rates. That's a rare phenomenon. It shows the quality of the work and product enhancements they've made. They shorten the product release cycle, iterate faster, now they do upgrades faster, and customers reward them with a willingness to pay more for the products. You don't see that every day.

GH: That's a great example but it wouldn't strike me you would have the expertise in that technology, yet you invested at an early stage. How do you gain the confidence to invest in a company that makes printed circuit boards?

JM: A lot of fund managers pride themselves on qualitative research, but more valuable is working off the full data set of a company-wide story. With Altium, we looked at competitor results to see what they were doing, and it was clear that Altium was gaining share the market while raising prices. I would never try to master the art of designing circuit boards.

GH: Isn't the major difficulty investing in an Afterpay or Altium that there's so much dependence on future growth, with P/Es of 50 or 80, or not even a making a profit. How do you convince yourself not so much about the current business, but the incredible growth trajectory?

JM: We get fired up about situations with self-reinforcing dynamics. The network effect is one of those. My affinity for networks is that it's hard to find any other business model where so much value can be created so quickly. The market is often shocked and surprised at how quickly it can all came together, and Afterpay is an example of that. By the time a lot of fund managers even understood the thesis, there was already a lot of value creation and millions of customers. We love companies with lots of optionality and Afterpay has that.

GH: Do you get most confidence from the business idea or is it about the people?

JM: It's a mix of both. When I came out of undergrad at 22, I thought investing decisions was about spreadsheets, but then you get out in the real world. In small caps, we are very focused on management. Small caps often don't have much of a balance sheet, they invest 100% or more of what they earn. So you are betting heavily on the capital allocation and the leadership skills of the team. We have visited the small companies we own an average of nine times. It's less of a factor for some of the bigger businesses we own. The more money you reinvest, the more important it is that the management gets all those things right.

We own Visa, and no offense to the team there, but I'm pretty sure it could be run by a ham sandwich for a year and most people wouldn't notice. There's a charm in that.

GH: You've had an excellent run recently, topping the Morningstar tables, but in the last five years, 'growth' has beaten 'value' across all sectors. Is the performance more than the right place at the right time?

JM: We ask ourselves this all the time. Every good investment outcome has an element of luck, for better and worse. We've had the wind at our back in terms of growth, and some of the industries we focus on have done well, particularly enterprise software. That said, we've selected well in those sectors, so it's not just sector tilts. We've focussed on enterprise software and recurring revenue business models but there's some degree of fortunate medium-term timing.

GH: In a recent article in Cuffelinks, you wrote about 'fascinations'. Tell me more about them.

JM: Most funds are built around trying to cover the waterfront. There's a guy covering North America, this woman's in media, it's sector based. We think there are big problems with this approach. You get pitched ideas from all your analysts, regardless of whether it's actually a good place to be investing because that's what you've told them you want.

Not all industries are created equally. Some historically have low returns on invested capital or volatile returns on capital. And some of them are at the higher end. I don't see a lot of appeal in focusing our time or capital on industries that might be melting ice cubes or price takers. Fortunately, here in Australia, many people focus on industries where that is the case, such as Materials, so we have less competition in other parts of the market.

Our ultimate objective is to construct a portfolio of businesses that we consider have superior long-term prospects and reinvestment potential. We spend a lot of time talking about the subjects that we're fascinated about.

GH: Have you got a couple of favourite stock stories?

JM: Sure. Audinate (ASX:AD8) is one of our favourites that not a lot of people are familiar with, and it's only covered by three analysts. The business has more than reached a critical mass. Its core product is a software protocol called Dante that

allows different pieces of digital audio to talk to one another. And it ran away from the competition because its product has the lowest latency. You could have a big auditorium, and your microphone will connect to the speakers in a clear way. There were people in the space before them, but because their product is functionally superior, manufacturers rallied around them. There is now a clear market winner and speaker manufacturers who were on the sidelines now see a leader so Audinate is gaining share of that market. Over 90% of their competition is just cables but digital is a better option.

GH: Is this, say, in a concert or conference set up, instead of cables running along the ground, the equipment is linked digitally?

JM: Exactly. It's a big improvement and a high margin business, and they are pushing into AV, such as in a sports bar with lots of screens, solving the same cabling problem.

GH: And a second stock?

JM: We've already talked about Afterpay. A lot of people understand the Australian opportunity but we think the US market, new products and extending the brand give a wide range of options.

Facebook is the biggest position in the Global Fund. The business could not have looked worse in headlines over the past couple of years, and they've made a lot of mistakes which they were rightfully fined for. But a lot of people look at the headlines and assume that the business is doing poorly or even shrinking. The opposite is the case. More than two billion people use the core Facebook business monthly and it's growing in every region. Revenue was up 30% in constant currency terms year on year. Then you've got Instagram, Whatsapp and Messenger, each of which has more than a billion monthly active users.

The Lakehouse Small Companies Fund owns shares of Altium, Afterpay Touch, and Audinate. Both Joe and the Lakehouse Global Growth Fund own shares of Visa and Facebook.

Charles Dalziell on life as a contrarian investor

22 May 2019

Charles Dalziell is an Investment Specialist at Orbis Investment Management. Orbis was founded in 1989 and manages over $50 billion in its Global Equity Fund from 10 offices around the world, including Australia.

GH: Orbis describes itself as 'investing differently', and in the article you wrote for Cuffelinks, you talked about the long game and the arduous process of investment research. But every investment involves some level of personal judgment. How do you make that final investment step between the empirical research and the subjective judgement in a concentrated portfolio?

CD: It is difficult, and can take months of work. Each analyst has to convince one of the five key stock pickers globally before a stock goes into the client portfolio. We have a formal policy group meeting where the analysts present their investment thesis to their peers, including to the global stock pickers. And the policy group will say, "Have you considered this? Have you considered that? What about these concerns?"

That isn't a decision-making meeting, although everyone at the meeting votes on whether it's a buy or a sell. But it's not a vote on whether it goes into the portfolio. At the end of the meeting, there are only two decision-makers. One is the analyst, who can say, "I like the stock. We've been through the key points, there's nothing that's changed my mind so I want to buy this stock for my paper portfolio." Their paper portfolio usually consists of about 10 stocks and analysts live and die based on the performance of that.

The second decision-maker is one of the five global stock pickers that direct capital into our Global Fund. One or more of those could say, "I think this is a really great idea. It fits well into our portfolio from a risk, return or uniqueness perspective. And I want to buy this in my slice of the portfolio."

GH: This is the actual portfolio, the client portfolio.

CD: Yes. Or they may just say that it might be a good idea but it doesn't fit in. Or they may not be convinced by the thesis. We make final decision-making an individual activity because consensus decisions don't work well in a contrarian style. We want individuals to back themselves and their own ideas and be accountable. The analysts probably would like to see the stock go into the portfolio. But if it doesn't, they have still bought it in their paper portfolio and they are rewarded if the stock does well.

GH: Even though the results are not reflected in the external fund performance?

CD: Yes, they'll be paid a bonus based on the performance of their own paper portfolio but conversely, if the stock does poorly, they might miss a bonus. The performance of that 10 stock paper portfolio will be tracked over time. It's designed for us to collect great data across the entire analyst team on who's got skill at picking stocks and who has the right temperament to be a contrarian investor. It's really not for everybody. And so we have higher number of analysts than we need because we know that there will be a high level of attrition in the early years. For some, it's uncomfortable and they don't like this way of investing.

Every stock must go through this process. We've got 34 analysts globally, with theoretically 10 stocks each, that's 340 stocks, but we only have 60 stocks in the portfolio. So most ideas don't make it.

GH: And given that analyst has spent three months researching the stock, and it's a big step for them to put it to this committee, do they often get talked out of it at that stage?

CD: They can do. It's intimidating, and they have to tick all the boxes and have a very strong investment thesis. We have divided the world geographically with a US team, Europe team, Japan team and emerging market team but we also have a global sector team, with a banking specialist, healthcare specialist, tech specialist, for example, which gives us the broadest possible coverage across the world. This means that we often have more than one analyst covering a particular stock or sector which leads to more productive discussions in meetings.

GH: How do Australian stocks fit into that structure?

CD: We have our association with Allan Gray in Australia, and the global team sees that research. We have one Australian stock in the global portfolio, Newcrest.

GH: In the article you said: "Stock pickers have to kiss a lot of frogs before they find the prince or princess." It's a great line. Are there common characteristics where companies fail to make the portfolio?

CD: Yes. First, we may do a lot of work and realise we just don't have a unique insight or something that differentiates our view from the market. Second, history might not reflect well on what will happen in the future for this company. We have amazing data sources and excellent filtering tools and part of the analyst's job is to establish that the stock looks good relative to history. But maybe we find questionable accounting practices, unusual executive remuneration, or strange depreciation schedules. Or the business may have changed, and while they used to earn 15% margins, now it's 5% because somebody came up with a better mousetrap, and we don't think 15% margins can be achieved again.

GH: Some other public funds turnover 200% of their asset size each year, with adverse tax consequences. For a business like yours, a long-term contrarian, what do you think is an acceptable turnover level?

CD: At a basic level, if your investment horizon is four to five years, then 20% to 25% is theoretically about right. The reality is that stock prices move rapidly which can influence turnover. For example, when prices are moving down, you may be allocating more capital into those stocks. So I don't think there's any hard and fast rule. But if a fund manager's turnover is high, it's usually because they are a trader. If a manager says they are long term, doing fundamental bottom-up research, and then portfolio turnover is 200%, you should ask some pretty hard questions.

I'm amazed nobody measures after-tax performance because it ensures fund managers have little incentive to think about the tax impact of turnover.

GH: The last five years have been difficult for 'value' versus 'growth' and a lot of stocks on high P/E ratios have just kept running. How has this played out for Orbis, and in particular, how have you managed your client relationships in that time? I'm wondering about patience for an explanation that goes for one or two years and how long that story can last?

CD: If you look at the last 12 years, we've outperformed even though value has underperformed growth. Yet 12 years ago, value was expensive. Everyone was a value manager and we were finding good growth names. Now there are very few value managers left and we are finding better opportunities in that space. We've gone through a once-off downward shift in interest rates that we've never seen before in history, and growth stocks are long duration stocks so they have benefitted.

We don't make big sector or macro calls, we tend to be focused on idiosyncratic single stock risks. We've owned all the big tech stocks over the last 10 years, but once our assessment of the intrinsic value has been realised, we tend to sell. When the margin of safety is gone, we move on because we think our competitive advantage has disappeared.

More recently, we added to a position in Facebook when it disappointed at the end of last year, because we think it's a terrific business. We haven't missed out on the tech side. The big tech companies have incredible cash balances and fantastic moats, with a lot of optionality, such as Facebook with Instagram and WhatsApp.

GH: And Apple has bought two dozen companies in the last quarter, so that's all about options.

CD: Options and plugins, things you can just plug into your infrastructure and your system and increase the value. So we're not dogmatic about being value managers and just looking for the lowest P/E or price-to-book ratio. We're thinking about discount to intrinsic value and growth has an important part to play in that estimate. The best stocks you can buy are growth stocks disguised as value, and we think we have a lot of those in the portfolio today.

For example, we own Naspers, a South African tech investment company that owns 31% of China's Tencent. Through Naspers, you can buy Tencent at a 45% discount. We own Autohome, a Chinese marketplace for new cars, a bit like Carsales. And we also have Facebook in our top 10 positions.

GH: Can we come back to the question about managing clients.

CD: Orbis does an amazing job educating our clients and ensuring we only attract like-minded clients. We are upfront about our history, and we say contrarian investing is not for everybody. Look at our history, there have been many periods in the past where we've underperformed our benchmark by more than 10%.

GH: Under the market, or drawdown?

CD: Not a drawdown but actually under the market. But over 30 years, we've beaten the market by over 6% per annum. The long-term numbers are great but the price you pay is short-term underperformance. As a contrarian manager, things will just go against you. And in the last 12 months, we've certainly seen that.

It's been a bunch of different things that have happened to the portfolio at the same time, and a couple have been mistakes. The majority of the performance has been stock issues that haven't affected the assessment of intrinsic value. In fact, it's made us more excited about the opportunity and we've added more capital into those ideas.

To date the clients have been extraordinarily understanding. Clients are not blasé about our performance, they ask all the right questions, but they understand why we are not performing in this particular environment. They can also see the opportunity. It's important to have the right clients because we will go through periods like this. And many are allocating more capital to us at this time.

I should also mention that we're owned by the Allan and Gill Gray Foundation, which is a charitable organisation. And that ensures perpetuity of ownership and also that when we go through a period of underperformance, we don't have a big brother demanding we change our process at exactly the wrong time.

GH: Do you have a couple of names where you think the market doesn't realise how valuable the companies are.

CD: XPO Logistics is listed in the US. It's a trucking and logistics company, but since mid-2018, its price is down around 50%. They downgraded revenue growth last year but to a level that is still above average for that industry, and they have economies of scale. There was also a short seller attack in 2018 and it got a lot of market coverage. We know this stock extremely well and we have a long relationship with the company. We hired a forensic accountant from New York University to examine the short report's claims and he did not see any cause for concern. XPO is one of only two US trucking companies that can execute on same day delivery and many retailers don't want to outsource to the other, Amazon, as they are often a competitor as well.

GH: And an Australian stock?

CD: The Allan Gray Australian Fund holds Newcrest. Nobody's investing in gold mines as the gold price is too low - we're at the marginal end of the cost curve. Newcrest is one of the lowest cost gold miners in the world with long reserve life.

GH: Last question. Does Orbis have any plans for a Listed Investment Company or Active ETF, to make access easier for an SMSF trustee or retail investor.

CD: We're on mFunds on the ASX, and on all the major platforms, or they can come to us direct. But no plans to list a vehicle at this stage.

This report constitutes general advice only and not personal financial or investment advice. It does not take into account the specific investment objectives, financial situation or individual needs of any particular person. Past performance is not a reliable indicator of future results. This interview represents Charlie's views at a point in time and provides reasoning or rationale on why Orbis may have bought or sold a stock for the Orbis Funds. Views may and do change as facts or circumstances change.

David Harrison on the hot spots in property

29 May 2019

David Harrison is Managing Director and Group CEO of Charter Hall (ASX:CHC), which manages $30 billion in property assets across office, retail, industrial and social infrastructure assets. It is a leading direct property fund manager, including open-ended funds available to retail investors, as well as manager of the listed Charter Hall Education Trust (ASX:CQE), Charter Hall Retail REIT (ASX:CQR) and Charter Hall Long WALE REIT (ASX:CLW).

GH: In 14 years, Charter Hall has gone from $500 million to $30 billion in assets under management. Are there two or three big decisions or milestones that created that growth?

DH: I joined the Group in 2004 when it was a private company. We had traditionally managed wholesale funds for major clients, plus a high net worth syndicate business. We needed to list on the stock exchange to give ourselves a balance sheet and allow coinvestment with large super and pension funds. After listing, we launched a series of large wholesale funds that created a growth platform for core, stable investments.

The other major event was in 2010. Banks were exiting the ownership of property and property funds managers, and we bought the Macquarie real estate platform. It had about $7 billion of assets, but half were offshore. We used its listed REITs (Real Estate Investment Trusts) to refocus purely on investments in Australia.

Then we realised that we could become the largest Australian provider of 'stabilised' (*Ed, stable, long-term income*) commercial property to the main sources of equity flow in the world. The clients in large super funds, global pension funds and insurance companies represent 65% of our funds under management. In unlisted assets, our retail high net worth business includes almost 30,000 investors and SMSFs.

GH: How should an investor decide between the types of product you offer, in your listed funds, unlisted funds or separate syndicates?

DH: We don't make the asset allocation decision. SMSF investors, advisers, high net worths, large super funds, asset consultants – they make those decisions. So we give investors a choice.

We run our own listed funds management business, the Charter Hall Group, plus three listed REITs: one in non-discretionary retail, one in the childcare sector, and the third is realistically the only diversified long WALE (Weighted Average Lease Expiry) trust listed in Australia. Other trusts are far more diversified, while ours has a long lease, low risk profile of assets from office, industrial, retail and social infrastructure.

In the unlisted space, we have two open-ended (*Ed, this means open for ongoing investment*) funds in the office sector (Charter Hall Direct Office Fund or DOF and Charter Hall Direct PFA Fund or PFA) and plus one in the industrial sector (Charter Hall Direct Industrial Fund No 4 or DIF4), and recently we created a diversified consumer staples fund (Charter Hall Diversified Consumer Staples Fund or DCSF). Following the acquisition of Folkestone, we now have the Charter Hall Maxim A-REIT Securities Fund, which offers investors access to a portfolio of listed A-REITs.

GH: Do you have any advice on how investors should choose between sectors?

DH: I encourage investors to look at diversification. Some don't want an office or industrial fund, they prefer a more diversified fund. Some people like to make the sector allocation decision because, for example, they might already have an exposure to shopping centres so they choose an industrial fund.

GH: If you look at Listed Investment Companies (LICs) generally, most of them are trading at a discount to NTA (*Ed, the value of Net Tangible Assets*). But if you take your Long WALE Fund, that is at a significant premium (currently, share price $4.84, NTA $4.01). Why is that?

DH: One reason is that some LICs are 'fund of funds' with double fees. You're paying a manager to invest in companies or funds that already have a management expense ratio. Other LICs are investing in listed companies that have their own volatility. The NTA now might not be the NTA in the near future. In REITs, the trust itself owns the direct real estate, and there's only one set of fees.

GH: Most people more familiar with residential leases don't realise how commercial leases work.

DH: Yes, especially the various 'net lease' structures (*Ed. a net lease is where the lessee pays some or all of the maintenance or other costs on a property*), such as on our diversified REIT (ASX:CLW), or Bunnings Warehouse Trust (ASX:BWP) or the two pub trusts (ASX:ALE and ASX:HPI) or the recent additions such Redcape (ASX:RDC) - although I think that's a combination of both opco and propco risk (*Ed. operating company and property company)* so it's not quite a REIT. And you have sector-specific REITs such as the Viva Energy service station REIT (ASX:VVR).

GH: Can we come back to other ways your listed and unlisted funds are different, because many retail investors would have less knowledge of the unlisted space.

DH: OK. There's no pure-play listed office REIT available anymore, arguably no pure-play listed industrial REIT of any scale, or not of the scale and style of our unlisted funds. Our flagship unlisted direct office fund, DOF, has $2.2 billion in assets. Our unlisted industrial fund, DIF4, has about half a billion in assets with a WALE of about 10 years.

Investors should not get sucked into the idea of a liquidity premium. When you invest in anything listed, yes, you get liquidity, but with that comes volatility. If you're a student of Sharpe ratios and risk adjusted returns, you want a slightly higher return for listed than unlisted to compensate for the volatility. But there are purists that say you should accept a lower return for the liquidity. It depends whether you're a long-term investor or whether you're just trying to time the market.

GH: With all these sectors to choose from – commercial, industrial, office, retail - do you have a current favourite which you think has the best prospects? What are the trends?

DH: Our house view on a five-year outlook is that office and industrial will outperform. We think large shopping centre REITs and retail will be under more pressure. Fortunately, we don't play in the top end of shopping centres like Westfield, nor in the discretionary end of the retail market. Less than 5% of tenants in our shopping centres are now fashion and apparel.

GH: Has that been a deliberate tenancy decision by you?

DH: Absolutely. We've stayed away from large regional shopping malls and we prefer smaller, convenience-based retail. Our retail fund (ASX:CQR) or SCA Property (ASX:SCP) have outperformed and are trading at 10% premiums to NTA, whereas Scentre Group (ASX:SCG) and Vicinity (ASX:VCX) are at heavy discounts.

On demand for office space, a reason we have not seen a contraction is that both employers and their people don't want to work from home. I took my entire board to the US to see Amazon and Google. Despite all its technology and new ways of working, Google does not encourage people to work from home.

GH: Why is that? What about the inefficiency of long commuting times?

DH: They think it's far more productive to have people working in a collegiate team environment than having them on Skype or video-conferencing from home. The reality is we just have not seen the reduction in workspace ratios due to working from home.

GH: In the wholesale business, are you seeing the large super funds move to internal asset management, such as AustralianSuper recently withdrawing billions from Australian equity mandates. Is that happening in property?

DH: It's definitely happening less than in the listed equities environment. As the CIO of AustralianSuper said, a lot of Australian equities managers have hugged the index and there hasn't been enough differentiation. It's more difficult in property. I've got 550 people on the payroll, it's difficult to replicate that, including the intensity of development activity.

GH: You're not just buying CBA or Woolies shares.

DH: Exactly. I've been through lots of cycles over 30 years and I haven't seen too many insourced direct property models work very well. It's different for listed equities managers.

Another difference is that all of our funds with performance fees are absolute IRR performance fees *(Ed. fee calculated on the positive returns*). There's none of this rubbish that if I'm a better loser than everyone else, I still get performance fees. I absolutely do not agree with that. There's got to be an absolute hurdle for positive returns.

GH: Many property funds went into the GFC with high levels of debt and crashed. Have the lessons been learned permanently, or will the excesses come back in the next cycle?

DH: Yes, it's a permanent change. Look at the average gearing across listed REITs at about 27% or in the $100 billion unlisted wholesale sector, average gearing about 16%.

Interest cover ratios - because of the low cost of debt – are up to four times higher than in 2007. There are still some syndicates gearing at 60% and that's a warning. Gearing is fantastic when asset values go up, but not so good when they go down. Risk is also amplified if the underlying assets are not backed by long-term, blue chip tenants with solid cash flows.

GH: If you had to identify one favourite sector, what would it be?

DH: I don't have favourites. I'm a big believer in diversification. But with the growth of ecommerce, unlisted industrial logistics funds will perform well over the next decade or two. The opportunities in distribution centres near large population centres catering for ecommerce are very promising.

Phil Vernon on rules for managing competing priorities

5 June 2019

Phil Vernon is Managing Director of ASX-listed wealth manager, Australian Ethical (ASX:AEF), which was founded in 1986. It manages about $3 billion for over 45,000 clients, with two-thirds in a superannuation fund.

GH: Every person who invests with Australian Ethical has their own set of ethics. How do you reconcile yours with theirs?

PV: There are three main elements to that: one is the rigour of our process, two is disclosure, and three, we test our preferences with our clients.

Briefly on each. **First**, as much as ethics might seem like a subjective issue, we try to make it as objective, analytical and rigorous as possible. I equate the hierarchy of our process to the way a country operates. There's a constitution, then legislation - which interprets the constitution in a rigorous framework - and then there's case law.

In a similar way, we have an Ethical Charter that sits in our Constitution, with our high-level principles. It includes 12 positives that we look for and 11 negatives we avoid. That's our starting point. Then we develop a set of ethical frameworks that focus on industry sectors and specific issues, with potential crossovers. For example, you might have animal welfare issues that affect different industries.

Many outcomes we look at must balance positives and negatives, so there's a lot of internal discussion which determines where we land on certain things. It's overseen by an ethical Advisory Committee, which is an internal management committee comprised of myself, the Head of Ethics and Chief Investment Officer.

That puts in place an objective standard in the way we view the world. It gives the investment team reasonable certainty on what they can look at. It allows enough flexibility so that if things change over time, and we have to adjust, we can have a robust discussion. That's why I pointed to legislation, which can shift, but we don't change on a whim.

GH: And **second**, on disclosure and transparency?

PV: Yes, on our website, we explain our position on 42 hot topics, such as on fossil fuels, climate change, animal welfare, human rights. You can see what we believe. We're very active on social media and we encourage people to offer their views. We invest a lot of resources and time in responding. Our ethics team will often give detailed responses and people are surprised by the responses they get.

GH: Yes, I've heard you have something like 120,000 social media followers. And the third element?

PV: **Third**, we check the mood of our community, including our members. We do an annual survey on ethical preferences to make sure that our judgments are in line with the general mood.

GH: Can you give an example of something that has changed over time, a community expectation that you've had to reconsider.

PV: The classic example is fossil fuels. One of our key ethical charters is environmental and we've always been strong on climate change. It's the key thing that our members care about. If we go back a few years, we were a supporter of gas as a transitional fuel to help manage the climate crisis. A classic case of balancing positives and negatives, as we have a charter to lower emissions but we also have a positive charter about human happiness and dignity.

GH: So we have to transition away from fossil fuels in a just way.

PV: Yes, 'transition' has become a common term but we were debating that 10 years ago. We reached the point where, after a rigorous debate with lots of external experts, we decided the urgency to adjust for climate change was greater than we previously thought. And the technology to allow a just transition had improved dramatically. For a host of reasons, there was no remaining justification to support gas as a transitional fuel.

GH: If there's an analyst in your investment team who finds a company they like, what's the ethical check on that investment? Do they do the ethical screen before they do the research? Or do they find the company and ask if they can invest in it

PV: It's a bit of both. The frameworks are done and we have a reasonable assessment of the investment universe, but there's still a lot of bottom-up identification of companies. We don't do 100% screening of the market up front.

GH: Do you think investors give you money for ethical or investment performance reasons?

PV: An outcome of our annual survey is that we categorise our investors, and there are four broad categories. First group

we call ‘Highly Ethical’, where ethical decisions are the dominant reason for investing. They're willing to compromise on performance or indeed, whatever market or product they are in, ethics comes first. That's about 10% of people.

Then there's a broader category covering about 40% of people which we call ‘Ethical Action Takers’ where ethics is a strong driver but they look at quality and performance as well. There are two sub-categories in there: people where ethics is the dominant driver and another where performance dominates.

And then there’s a bunch of people where ethics isn’t really a driver at all.

Historically, we've come from people whose dominant decision was the ethics, and they were probably willing to compromise. But it’s changing, and our members are mainly people who want the ethics but not with a compromise on performance.

GH: All fund managers now talk about their ESG (Environmental, Social and Governance) principles. Do you think that the ethical side, which has been part of your DNA since the start, is now less of a competitive advantage than it used to be?

PV: No, there’s a distinct difference. ESG as a philosophy still puts the financial decision as the primary driver. The ESG issues are relevant only where they can demonstrate improved company performance, They are an input to the investment decision.

Our philosophy is quite different. Our ethical conviction exists in its own right, but our belief is that you can make that decision and not compromise long-term performance. So, yes, there’s more competition in that space, but the conscious consumer recognises the distinction.

GH: How do you hire staff? When you're interviewing someone, they must try to interview well and tell you about their ethical values.

PV: It's a really important point. We want a culture where people actually live and breathe the values that we stand for. It's always a judgment but it is an explicit part of our interview process.

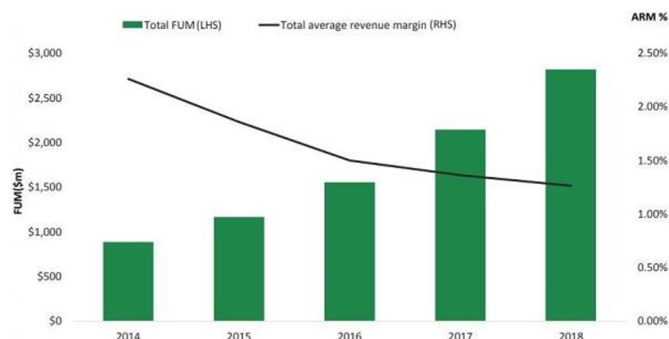
GH: What do you ask them?

PV: We ask people to talk about things they’ve been involved in, what they have an interest in, and we allow them to elaborate. One of our corporate values is authenticity, so we search for the authenticity in the answer and sometimes you don't get it. Often, it's obvious that the person is telling us what they've practiced in their response. You can pick it.

GH: There's a lot of debate in the industry about why fees don't fall as funds under management grows, as fund managers achieve scale. How have you coped with that issue in an ethical business with responsibility also to shareholders?

PV: We have a distinct philosophy of sharing the benefits of scale with our customers. You can see how our fees have come down in the last five years. We used to be an average fee margin of about 2.2%. We’re now down to about 1.2%, so we’ve given 1% back to our customers as we've grown.

(Ed. Phil showed me this chart where the black line shows the average revenue margin falling since 2014 against FUM).



PV: I wanted to mention that I read your book *(Ed. ‘Naked Among Cannibals’, published in 2001, about failures in the way the banking system operates)* many years ago. It was around the time I was reading a number of seminal works that ultimately led to me being here, challenging what was wrong with the normal corporate model, and your book was a master at calling a lot of that out.

GH: Thanks. And 20 years later, we had a Royal Commission.

Adam Grotzinger on global bonds for diversified income

13 June 2019

Adam Grotzinger is a Senior Portfolio Manager at Neuberger Berman, the manager of the listed NB Global Corporate Income Fund (ASX:NBI). Neuberger Berman manages almost $500 billion across all asset classes in 35 offices worldwide.

GH: Why do individual Australian investors and SMSFs underallocate to bonds compared with Australian institutions and particularly overseas individuals?

AG: A few reasons. Australia does not have a heavy bond issuance calendar and there’s not a big local bond market that retail investors access. If you're a domestic investor, it's natural to invest in your local market. Yes, there are government bonds, but outside of that, supply is choppy. It’s different overseas. Those are bigger, deeper, more liquid bond markets, particularly in high-yield bonds.

Investors here traditionally achieved a good fixed income return in term deposits but that's eroded now, and it’s likely to get worse. Adding to that, investors had bank capital

securities such as shares or hybrids to achieve an income stream. That has worked well in the past but people are now thinking harder and deeper whether that is achieving their goals, and how much concentration risk are they taking.

GH: Indeed. Bank TDs, bank shares, bank hybrids … it's all an exposure to residential property, the same as their house and perhaps investment property. And people think they're diversified.

AG: Yes, and with the low level of rates in Australia, investors are looking abroad and saying, "Actually, there are better yield opportunities out there. And some of those give me a different type of exposure than I have here." And that's powerful because it's further diversifying their portfolios with a yield element to it.

More people are entering retirement and there's greater desire to reduce the price volatility in portfolios, and prioritising consistency of income. So there's a demographic argument as well.

GH: Tell me about Neuberger Berman. How does a business with almost $A500 billion under management and 600 investment professionals coordinate its investing? How does an individual Portfolio Manager have a say in the portfolio?

AG: We're comprised of various teams managing money in different parts of the capital markets. One of the larger teams manages corporate credit, comprised of 55 people managing US$60 billion of assets for clients globally. In the context of NBI (*Ed, the listed Australian vehicle, ASX:NBI*) in the corporate bond market, we have analysts, portfolio managers and traders in the team. The analyst jobs are sector- or industry-specific coverage, and the companies issuing within those industries. They are accountable and compensated and responsible for their views on which companies will outperform. The analysts make formal recommendations to the broader group, and the vetting of the decisions is done by our credit committee.

GH: So the actual investment decision is made by the team?

AG: Yes. It's highly integrated. The analyst makes the case to credit committee, but the credit committee is comprised of the analysts, the co-heads of research, all the senior Portfolio Managers. The buy decision must be unanimous.

GH: Unanimous is quite a hurdle with so many people involved.

AG: We've done this for 20 years and in many cases, we have a lot of documentation and a rich history of these companies that we've covered for many years.

GH: The breakup of your portfolio is about 90% into BB and B rated bonds but there's a 7.5% piece which is CCC. How are you comfortable with these non-investment grades?

AG: When we think about the high-yield corporate bond market, the rating definition is BB to CCC. We anchor the portfolio in BB and B, that's really our operating slot through points in the cycle. When we get more defensive in advance of an expensive market or maybe the economy is slowing, we rotate up a bit higher in quality to triple B, which is technically investment grade.

But we want to stay fully invested, because income is a priority and cash drag is a problem. And after the bottoming of the economic cycle, when the recession bottoms, we can get more aggressive, and buy the CCCs for the price and quality bounce. So in NBI today, we have 7% in CCC, but we've been as low as zero percent leading up to the bottom of the economy. Positioning for rebound, we've held as much as 25% in CCC.

So the low 7% weight in NBI today reflects that we're going through a slowing in growth in the global economy. Our central thesis is a lower but durable level of growth, which can extend the cycle longer here. The 7% in CCC is a much smaller exposure than in an index bond portfolio.

GH: A portfolio with 450 holdings and 300 issuers must have some losses. What default rate would you expect?

AG: Our goal as an active manager is to understand which companies are likely to deteriorate in future, and we've only had one default in 20 years of investing in high-yield bonds.

GH: Really? I thought the default rates for BB and B corporate bonds was about 2% a year and higher in the GFC, and CCC much higher.

AG: Yes, there have been over 1,000 corporate defaults over that period. But as well as understanding the quality of the businesses, liquidity is vital. We want to transact out of the bonds if we feel our original thesis has changed. If you own a bond today, you have a thesis, you have a view on management, you have a view of the business model and how they will service their debt? If in a year's time, that thesis changes, you can sell into the market.

GH: Okay, you don't have defaults but you might have sold a deteriorated position.

AG: That's right, that's our second bit of protection as a manager. If something doesn't pan out, we can sell the bond at two or three or five points below where we bought it. So we are realising a bit of a loss but it's more prudent risk management than riding that bond for another 60 point loss to wherever the markets will price its recovery value. We want to avoid that tail risk.

GH: In the GFC, regardless of what you owned in the non-government bond space, spreads widened and prices fell. How did the high-yield portfolio go in those years?

AG: Very interesting. For the two-year period, 2008 and 2009, if you bought this asset class passively as an index investor, you would have returned negative 27% in 2008 and plus 58% in 2009.

(Ed. At this point, Adam showed me the slide below).

					INTERNET BUBBLE BURSTS						GLOBAL FINANCIAL CRISIS							COMMODITY COLLAPSE				
RETURNS (%)[1]	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	YTD 2019
Neuberger Berman U.S. High Yield Composite (Net-of-fees)	7.6	5.6	-1.3	6.2	3.8	27.7	8.7	4.8	10.1	2.2	-17.8	52.6	15.2	4.1	15.6	7.7	2.0	-4.1	14.8	5.8	-2.1	7.1
Benchmark	2.9	2.4	-5.2	4.5	-0.5	28.0	10.9	2.8	10.8	2.5	-26.1	58.1	15.1	4.4	15.6	7.4	2.5	-4.6	17.5	7.5	-2.3	7.4

Source: Neuberger Berman as at 31 March 2019, benchmark is BofAML US High Yield Master II Constrained Index.

AG: In our portfolio, the bonds were still marked down, but we invest in more durable businesses and we had no defaults. In 2008, we were marked down 17% versus the index's 26%. Then at the end of 2008, we started rotating into risk again,

we bounced with the market, but not as strong. We were up 52% versus the market up 58%. It was powerful for our clients. We had a better return than the market, but the income throughout that period was not compromised. The coupons were still coming in each morning albeit with a lot of price volatility. And that price volatility was still far superior to shares. Over the last 10 years, global high yield has an annualised volatility of about 7% versus global equities around 12%.

GH: So you need to educate your clients to hang in during tough markets.

AG: And share our view of the underlying businesses and our confidence in them. Bonds are very different from shares. They have legal, mandatory payments through a coupon from a company. The market marks down the bond but it is eventually forced to get its head around whether this company is solvent or not.

GH: The duration of the book is about four years, which means interest rate risk in a very low rate environment. Why are you comfortable with that?

AG: This asset class does well in periods of rising interest rates. If you looked at the first three quarters of last year, the high-yield market outperformed investment grade bonds when interest rates were going up. What's usually driving higher yields is the economy is doing well, and if you translate economic growth into these companies and their businesses, that's improving their revenues, earnings and cash flow. Markets have more confidence that they'll be able to service their bonds, resulting in tighter credit spreads. This fall in spreads absorbs some of the rise in underlying government bond rates and results in a strong price return for high-yield bonds.

If you look at the period from 2000 to 2016 for rising rate environments, the median rise in US Treasury yields was about 90 basis points (0.9%) over a three-month period. And what did high-yield do in that same three-month period? It delivered a positive 2.4% return. And then in the subsequent three months, after interest rates stabilise a bit, you get even stronger returns. The economy's doing well and markets rally. The opposite is true in investment-grade bonds, which have a smaller coupon and longer duration … this is becoming a long-winded answer …

GH: No, it's an important point.

AG: The other factor is a fat coupon is very powerful. It compensates for some of the default risk we talked about, but it also compensates for the interest rate risk. For example, if the bond has a four-year duration and rates go up 1%, in theory, this will be a 4% loss of capital. But if you're earning a 5% coupon, it can bring you back fast.

GH: Most closed-end funds listed on the ASX, in the Listed Investment Company space, trade at a discount to their Net Tangible Assets, the NTA. Why will NBI be different?

AG: This product is built for an income objective, which is defined by our target distribution that we broadcast to the market each year. It's different to a LIC where the underlying assets are shares as we own less-volatile bonds. The objective is more transparent in a way because people are buying into the target distribution for their portfolio. And to the extent we're achieving that target, seen on a high frequency basis, every month, it should create the right community of investors. They should not have a reason to sell it.

The community that owns a share LIC could have vastly different expectations about why they invested in that LIC and what they want from a return or income perspective. And that creates greater volatility in terms of buyers and sellers.

GH: So you want to see it trade at NTA.

AG: Yes, the proposition is straightforward about income. After our IPO, it did trade at about a 3% premium, so the way we can reduce that premium is by issuing new shares. That's what we're doing this new offer, after feedback from existing and potential investors that they would like to build more exposure to NBI at NTA.

GH: How does your portfolio differ from the high-yield index?

AG: Substantially. There are about 1,500 companies issuing bonds in our defined market, and we own about 300. We're not taking undue idiosyncratic or individual name risk but we're not owning the whole market. We can be selective on issuers, on credit quality, on industries, on relative value. Today, the portfolio is more heavily skewed toward defensive industries than cyclical types of businesses. That's a reflection of market valuations.

James Abela on companies, from toddlers to nightclubs

20 June 2019

James Abela is Portfolio Manager for the Fidelity Future Leaders Fund, which has won the Morningstar Fund Manager of the Year Award for Domestic Equities Small Caps for 2018 and 2019.

GH: James, your fund invests in small cap stocks. How do you define your investment universe?

JA: It's basically from a market cap on the ASX of about $200 million at the bottom end to $10 billion at the top end. I look at the All Ords, which is 500 stocks, minus the top 50. So that's 450 names and the fund owns around 50 of them.

GH: Many of those companies are not as well researched as the larger caps. How do you develop an understanding of the business and competitive advantage of a smaller company?

JA: I have three specific pillars: viability, sustainability and credibility. I call these the 'three pillars of success'. If there is a high return on capital, stable or growing, and a market penetration curve the company can monetise and deliver a return on capital, that's the **viability**.

The **sustainability** or durability looks at debt, cash flows, good pricing power, closeness to customers, prominence in the marketplace … all that tells me about a strong position that can last a long time. And then the **credibility** comes down to management, good accounts and strong governance. They are the keys. If you have these pillars, the chance of success is high, and the company has the potential to be a future leader.

In my experience, disasters have all come from that last pillar, which is credibility. The companies that blow up usually have accounting or management questions, reputational issues or governance problems. They're the red flags not to own those companies.

GH: A lot of CEOs are in the role because they have a big personality, and they're good at promotion and marketing, especially at smaller companies. How do you see through that?

JA: It comes down to the discipline of the viability, sustainability, credibility. Do they understand the accounting and finance disciplines, the markets they are in and the market power they have? Recognising the storytellers is where that last pillar is important. It's one thing for a CEO to build a billion-dollar business, but to build a billion-dollar business that's sustainable is a whole new ball game. You see companies go bankrupt within three years of listing after reaching a market cap of a billion dollars at the peak, and they end up disappearing.

GH: Do you look for different skills, and perhaps even a change of personnel, in the sustainability stage versus the original building phase?

JA: Not really, no. It's more about the value system of the leadership. Personal integrity is important. Integrity in their business, governance, accounting and their markets. You look for the ways they speak and behave, the KPIs they focus on. Avoid those who are very short duration, flashy and with a heavy focus on company size. It's not a sustainable value system in terms of credibility of the business.

GH: We've seen a lot of examples of companies creating immense value within just a few years. Does the relative inexperience of the management throw up any problems for you?

JA: There's two aspects to it. One is the personal maturity of the leadership, and the other is the maturity of the business. And when I think of small caps, the journey from IPO or small cap to large cap is a 12-year journey.

GH: 12 years as a listed company?

JA: Yes. I think of a school teacher watching children. The kids start off at preschool and junior school, which is small cap, and then they go into high school kids, which is mid caps. And if they are successful in high school, they can become leaders in their industry. It's a 12-year journey. So when you see companies that have not been around more than six years, you're dealing with a junior school mentality. It's a young company in the world to be less than six years old. They can be very exciting and they can become multi-billion dollar companies in a short period of time. But the business maturity and perhaps the management maturity is not yet proven enough for them survive through to high school and get promoted into the ASX50.

I like founder businesses. Wisetech is quite different. This is a founder business that's been going for 20 years. So that's like someone who's already been to university with a master's degree. It's a different maturity profile that provides me with a lot of comfort, even if the company was unlisted for a long time. But a business that is just an idea and more of a concept that doesn't generate cash flows and earnings is where I'm more cautious.

GH: That's a good segue to the Toddler Index, which is something I hadn't heard about until I read some of your material.

JA: Yes, it's something I put together using data from Macquarie Research. Toddlers are companies in the index that are under three-years-old. When you have a large percentage of the index in companies which are very young, say toddlers are half the index, that's when the market is at its peak. In the year 2000, in 2007, and late 2016, either the micro cap index or the small cap index had the number of toddler companies as a percentage of the index greater than 50%.

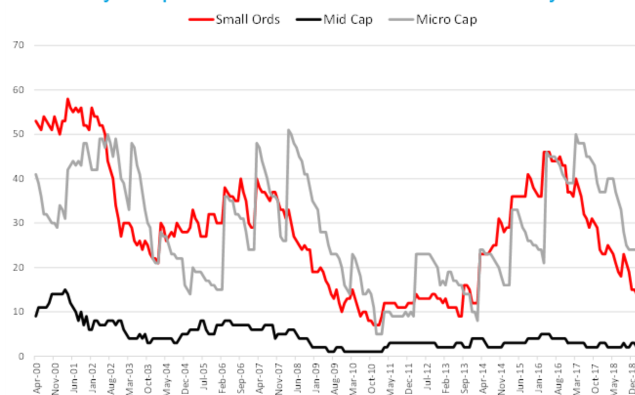
And we all know what happened in 2001 and 2008 and then 2017. Reality bites on these companies, and the reality of competition and the return degradation strikes. Then IPO activity falls off a cliff, and the toddlers go to school and realise there are systems and behaviours that they need to abide by.

GH: So where are the percentages at the moment?

JA: They've gone down to 30 and less than 20. Since the end of 2016 to now, we've gone down from 50% due to a softer IPO market, but also a maturity and a seasoning of earlier IPOs. On average, 70% of them are more than three-years-old, which is actually much more normal.

(Ed. At this point, James showed me this chart on company age since listing).

How many companies are in an index that are under 3 years old?



Source: Macquarie Research

GH: It's an interesting idea. What else does it tell you?

JA: It signals times of high liquidity, an arbitrage between private markets and public markets, a high risk tolerance and

optimism among investors, and generally a good economic cycle. Now that it's come down, it means that the risks of IPOs and the risks for young companies are probably closer to a floor than a peak.

GH: Many non-professional investors struggle with market timing. When the market is up with a good momentum, people want to get on board and they create a cycle of buy high sell low. And a lot of companies who may not be great quality are carried along on the tide. How do you separate that momentum of the market versus identifying a genuinely good company?

JA: Momentum is a specific thing for me. I think about it like a nightclub, and it's about sentiment, confidence and liquidity.

GH: Like when Chuck Prince of Citigroup said in 2007, "*As long as the music is playing, you've got to get up and dance.*"

JA: Yes, the music's on and the momentum now is still strong. But for me, you need to be careful as you mature in life, you realise you need to leave the market, the party, when you're happy and you've had enough. You don't stay there until you're feeling ill or there are no taxis or there's excessive alcohol consumption. You need to leave at a sensible time.

GH: It's a good analogy.

JA: And for me, a sensible party time is the same as a sensible investment time. You take away the liquidity, remove the exuberance, and see what you have left. If you have cash flows, you have profits, you have sustainability. Momentum is very generous. You need to take away that spirit, that sentiment and courage and look at the hard reality of the business. Then when the market does fall, you're faced with lower liquidity. And all those companies that have been feeding on the liquidity and momentum and strong sentiment but not much else will be facing bankruptcy, as we saw in 2008.

GH: So we're in the nightclub and we're having a good time, and it feels late … what time is it now?

JA: It feels like about one o'clock right now. And by two o'clock, you definitely need to go. The bull market has been running too long, it's been too generous with cheap money driving all these bubbles around the world. There's a tech bubble, US markets are outperforming, junk bonds have 2% yields. It's the chase for yield which happened in 2008 which means a degradation of the price of risk.

GH: Are there particular sectors that you like or dislike now, something that you've identified that the market is not correctly pricing.

JA: A lot of things are fully priced right now and there's not a lot that's undiscovered. I'm more focused on what I think is sustainable. Selectively, I like parts of health care and technology, but some of the fintech sector is excessive in terms of valuations. There's a lot of exuberance and a lot of excitement, but valuations are in the danger zone.

James Maydew on how demographics drives real estate

27 June 2019

James Maydew is Head of Global Listed Real Estate at AMP Capital.

GH: How do you manage global real estate selection from Australia?

JM: We have team members all over the world. We firmly believe that real estate is a local game. Boots on the ground are really important. We have teams in Sydney, Hong Kong, London and Chicago operating across every time zone. My own location is not the most important issue, the locations of my team are.

GH: And do they go out and kick the tyres on every asset you buy?

JM: We're investing in listed securities, so kicking all the tyres is hard because there are thousands of properties. But it's important to engage with the company and understand the management team and the second layer, the third layer, the fourth layer of the team. And seeing the real estate is vital. I'm a real estate person by trade and our team understands the bricks and mortar. We all travel a lot.

GH: How do you cover Asia and what are the opportunities there?

JM: We think about AsiaPac as a region, and we have a team here in Australia and a team in Hong Kong. The primary markets are Hong Kong, South Singapore and Japan, and we also cover China, the Philippines, Korea, India and Vietnam. We have three people in Hong Kong, and our most recent hire there is a native Japanese investor because Japan is a difficult market and you definitely need local connections.

GH: What's the global distribution of your assets?

JM: About 60% in North America, 25% is in AsiaPac, and the balance is in Europe. It's a US-centric capability. The US is the most liquid and deepest real estate market in the world, with the most opportunities.

GH: Other than the size and liquidity, is there something about the dynamism or growth of the US that attracts you there?

JM: Well, think about the asset classes. It's not just the three typical groups that you see in many other parts of the world, which are retail, office and industrial. The US has many other exciting sectors. There's multi-family residential, manufactured housing, storage, aged care, healthcare, forestry, prisons, data centres - all in the listed format. They are truly institutional. It will take 10 years for Australia to look like the US does today.

GH: What are some trends, demographic or consumer or company, that you really like?

JM: Demographics drives everything. We have a massive focus on long-term demographic trends. For example, we've got 20 years of Baby Boomer retirement, which will put pressure on aged care facilities and the healthcare system. How do you manage health? We're invested in companies that focus on life science, which is combating health challenges. About 10,000 diseases exist and only 500 have been dealt with. That's a long runway.

On the other side of the coin, we have the Millennials and their acceptance of technology, and how they interact with consumption. Commerce on mobile devices is still in the early phases of its trajectory. Retail is going online and we want exposure to the industrial facilities that benefit. In the US, for example, there's far too much retail, so you have to watch that segment. Index funds are simply not managing that risk.

GH: So the success in industrial of Australian companies like Charter Hall and Goodman is happening all over the world?

JM: Absolutely. In fact, Australia is playing catch up. The UK is leading, there is greater ecommerce penetration in the UK than any other market in the world.

I'm now thinking about 5G, because a lot of real estate investors ignore it. It's positive for three sectors in particular: logistics and ecommerce, communication towers and data centres. Data is growing at a phenomenal rate, and with 5G the demands and the movement to the Internet of Things will create even more data.

GH: You mentioned manufactured homes. What demographic change is that tapping?

JM: It's also linked to the ageing population. In the US, affordable housing is a massive issue. Manufactured housing is an affordable alternative to owning your own home or renting. We focus on housing parks that are located in the warmer southern states, which attract the snowbirds, including from Canada.

GH: Older people are tired of the cold?

JM: Yes, they want a higher quality of life and for many, that means better weather. The parks we focus on are typically age-restricted, and provide a service with the facilities and environment for people to engage with like-minded folk. It's not about trailer parks or the lowest cost alternative. It's a community location for retirees.

From an investment perspective, the return on capital is strong because we typically own the land and the tenant owns the building. They manage and pay for the cost of the maintenance and upkeep of that building, and they pay for a ground rent and the services. Rental growth is consistent and it's recession-proof because it's affordable housing. Not everyone sees that as institutional real estate but we look at the cash flows for our investors.

GH: In Australia, institutions struggle for exposure to residential property but there are better opportunities overseas, such as multi-family dwellings. Do you have much exposure to residential overseas?

JM: Well, just looking at the US multi-family market, it's absolutely massive, about 8% of our benchmark.

GH: What's the benchmark?

JM: It's EPRA NAREIT (*Ed, European Public Real Estate Association North America Real Estate Investment Trusts*). These residential apartment buildings are considered truly institutional. The servicing is done with technology using professional management and it's coming to Australia.

GH: This is where a fund owns an entire building with say 200 apartments in it?

JM: Yes, and they have the systems to understand the best opportunity to push up rates when occupancy is full, and create an environment and facilities which people are willing to pay for. They make it a great place to live, and people stay or come back.

The German residential market has also become a massive investable universe. Unlike Anglo nations, Germans don't tend to own their own home. They're happy to rent but not for one year, more like 12-year leases. It's logical. Just think about the financial leverage and risk to acquire a single asset with no diversification benefits. And then they sign a 25-year mortgage to pay it off.

GH: And their first investment outside their home is residential investment property.

JM: More people should think about using their own capital to invest for better returns and their dwelling is just consumption. But the Anglo mindset is different.

GH: Do you have Australian assets in your global portfolio?

JM: Yes, Australia is a really important market for AMP Capital. The main sector that excites us today is industrial. We believe Australian industrial is five years behind the US and UK with significant growth to come, and investors are underpricing it.

GH: Do you have a couple of listed favourites in Australia?

JM: Well, it's difficult to play the industrial sector in a highly diversified way. Goodman Group and Charter Hall have done well. Some people think they are expensive but we believe they will grow significantly larger in a sustainable way. They have capital-light business models.

Industrial is about the reconfiguration of supply chains and it's multi-level. The factories that were near the cities have become redundant and are often converted to residential or office or whatever else. It means the industrial supply, or land close to the consumer, has been shrinking. And that's a global issue at a time when the customer expects delivery of products in a very short period. If you don't get that, your business is not viable.

GH: The whole last mile trend as well.

JM: Yes. We believe rental growth expectations in this asset class are understated because there will be a step change in the ability of landlord to move rents up. Even a bricks and mortar retailer must deliver products quickly. The most expensive part of supply chain management is transportation, typically 50%. So if they can cut that down by being closer to the customer, they can invest more in real estate, which is typically under 5% of costs.

GH: An investor looking for exposure to this space could just say, "I'm happy with this asset class, I'll just go into the index

and save active fees." How does your fund differ from the index?

JM: So this paper that I've written brings that to life, focussed on the Australian market. (*Ed, attached here in our White Paper section*). Billions of dollars in this sector have gone into passive investing, and that's been okay in the past. But in future, investors should not buy a passive fund because half of the assets are in a declining retail segment. There's a strong case for active management in this asset class.

GH: Listed property performed terribly during the GFC. Have the lessons been learned?

JM: Yes. Australia was the poster child of all of the things you should not do at the top of a real estate cycle. Leverage was too high, management teams went into markets with no competitive advantage, overpaying for assets and not managing their debt.

So where do we sit now? None of those companies or boards or investment committees ever want to go back there. The lessons have absolutely been learned. Most businesses have reduced their leverage in line with the cycle. They respect the cycle.

There's also better understanding that the real estate market is more localised, driven by local real estate cycles.

GH: It's about that building in that location …

JM: Exactly. So people talk about the challenges of retail, but you can still have some great retail. You have to understand the socio demographic. The way we see active management is that when a market becomes more challenging, we'll sell that market and move money elsewhere.

The managed fund can be accessed on the ASX via the AMP Capital Global Property Securities Fund (Unhedged), ASX:RENT. For the White Paper by James Maydew, click here.

Nathan Hughes on consistency in strange markets

10 July 2019

Nathan Hughes is Portfolio Manager for the Ethical SRI Fund at Perpetual Investments.

GH: Nathan, how does the Ethical SRI portfolio differ from other Perpetual funds which no doubt have an ethical screen as well?

NH: Fundamentally, the Fund draws on the same philosophy and quality filters that we use across the broader equities team. However, a two-stage screening process is overlaid on top of that. The first stage excludes companies from the investable universe when their activities are deemed too ethically unacceptable, at a 5% revenue-materiality threshold. Some examples are the manufacture or retailing of alcohol and tobacco, and fossil fuel production.

The second stage looks more at how a company acts, and we score companies both positively and negatively on a range of SRI (*Socially Responsible Investing*) factors. A company must have a net positive score to be included in the ethical universe. I build my portfolio from there with additional filters.

GH: So how does Perpetual screen for responsible investing across all portfolios?

NH: ESG (*Environment, Social, Governance*) is incorporated into our decision-making process for all equity funds and we've been a long-standing signatory to the UNPRI. The overall process is about balancing out those risks and potential rewards for investments. My Fund is different in that it's very explicit. Clients can invest in the Ethical SRI Fund knowing that it will not buy certain kinds of companies. There are hard and fast rules on what's in and out.

GH: Okay. Is there a committee process that you go through?

NH: Largely, the process relies on the objective, two-stage screening and filtering. We also have Richard Morris, who is Head of Responsible Investments, as the ultimate arbiter of the investment universe. As the Portfolio Manager, I'm given a list of companies I can invest in and I'm independent of the screening process so I'm not trying to squeeze companies in or out.

GH: Can you give an example of a company that's in the broader universe but not in yours?

NH: The easiest examples are the big resource companies which are excluded from the ethical universe on fossil fuel grounds. So for example, Woodside, Santos or BHP Billiton. A more topical example is Commonwealth Bank, which was excluded from the ethical universe over 12 months ago based on corporate misconduct. There was a pattern of behaviour and events over a period, but that assessment is reviewed on an ongoing basis.

GH: Fund managers often get criticised as custodians of capital for not doing enough to change companies for the better. Is your approach more speaking at AGMs or in the media or behind-the-scenes?

NH: It's a range. Our preferred method is to talk to companies behind closed doors, and we certainly do engage with boards. But we have a history of going public as well, if we feel like our message is not being heard. Brickworks is the best example.

We are stewards of other people's capital and we have a fiduciary duty to look after it and grow their investment, to ensure that companies are acting responsibly and in a manner that can hopefully generate the kinds of returns we expect.

GH: Has ethical or sustainable investing moved beyond 'coming of age' to become part of the market noise and potentially investors are jaded by the story?

NH: Funny you should ask that. I wouldn't say 'jaded' given its ongoing popularity, it's growing strongly and investors are more active, especially the younger ones. They want more data on how their money is invested and what the companies are actually doing.

But you are right, there is an enormous amount of noise in the market as well, particularly on the ESG factors. There's a lot of data and much of it is inconsistent and noisy, and some of the things that we're looking at are hard to measure. Some of the social elements can be fluffy and difficult to quantify whereas things like emissions and energy intensity are easy to understand.

It is tricky, but it's an area in the market that people are interested in. We must be transparent about our product and what we're trying to do, but we can't be all things to all people.

GH: The removal of resources companies from your portfolio obviously creates tracking error versus the index, and there's an issue that some ethical themes will take 20 or 30 years to play out. But performance is judged every month. Is that a challenging communication issue?

NH: Not really. We demonstrate long-term thinking and we're not trying to outperform the market every day, every week, every month, it's just impossible to do. We have a process and philosophy here which has been out of favour recently, but obviously we're sticking to it. It doesn't change.

GH: Are there any trends that you've identified that the market underappreciates?

NH: We're not big on macro trends, our process is more bottom-up, research-driven. But any company that ignores sustainability, in my view, that behaviour just cannot go on. Most large companies are taking disclosure seriously. It's become a key part of their business proposition, and that's a trend some small companies must catch up with. Some of what we call ESG is simply good business practice, such as safety or employee engagement and culture.

GH: How do you feel about this market disconnect with interest rates at all-time lows suggesting economic slowdown, and equity markets at all-time highs, suggesting good trading conditions?

NH: Markets are in a very strange place. Even the Reserve Bank Governor can't understand why rates imply a slowdown while equity investors and credit investors are complacent about risk. We believe lower risk-free rates can justify higher valuations but that's only one part of the equation.

The other part of the equation is the outlook for earnings and margins, and according to companies we talk to, margins have probably peaked in the near term. And that is obviously negative for earnings and indicates lower growth in future. We also find puzzling some of the extreme valuations being paid for growth companies, which are now talked about in multiples of sales to justify their prices.

GH: It's hard to have a P/E ratio when there's no E.

NH: Yes. There are some companies where significant upfront investment costs such as customer acquisition expenses are going through the P&L as opex (*operational expenditure*) whereas historically we may have seen these costs go through capex (*capital expenditure*). There are many examples, such as Xero and previously Aconex, and this accounting treatment can mask true profitability or earnings growth over time. However, we think people get lazy and apply that thinking to a range of stocks. There are stocks trading at 20 to 30 times sales with a great hope of profitability at some point in the future. Many of these stocks are set for disappointment, as growth expectations may not eventuate. There will be exceptions, but many expectations are just too high.

GH: So other than the WAAAX companies, are there other examples?

NH: There's a company we used to own called Pro Medicus, PME, which is a fine business, strong growth, fixed cost leverage, high margins, but it's priced at 50 times sales. It's well-managed, but we can't get there on valuation. Nearmap has a great narrative but the earnings delivered so far are quite small. In the US, many big listings carry a history of losses.

GH: On the subject of history, Perpetual has a long history of developing some of the highest-profile fund managers in Australia, going back to Peter Morgan, John Sevior, Matt Williams. Is there something about the culture or training that produces that sort of person?

NH: We think so. The philosophy and the process are critically important, and they stay consistent over time. One way we do that is by encouraging promotion from within. Our current Head of Equities, Paul Skamvougeras, worked externally for a period of time but his two stints here cover two decades. He started in the back office and got a job as a dealer for Peter Morgan. Many of the team have come through the ranks and it's important that our process and culture are maintained. We add quality from external places where necessary. Our investing rules are not negotiable, and they've stood the test of time.

For White Papers by Perpetual relating to Nathan's portfolio, see The Perpetual Ethical SDRI Fund and Our Ethical SRI Screening Process.

Megan Scott on multitasking in a COO world

25 July 2019

Megan Scott is Chief Operations Officer (COO) for Martin Currie Australia, a Legg Mason affiliate.

GH: The Chief Operations Officer has been described by Accenture as the least understood role in business. What does a COO do?

MS: Other industries would be different, but the simplest way to describe my role is that our business has three parts: investment, distribution and operations. Operations supports the other two while looking over the entire business, including compliance, human resources, technology and office management.

GH: I expect as you went through your education, you did not set your sights on becoming a COO one day. How did you reach the role and what skills do you need?

MS: That's right. I did a BA at university because I wanted to learn broadly, then I worked in travel before stumbling into this industry through a friend. I really enjoy the operations side. Obviously, organisational skills are critical, and I've always been the person who had the list going and making sure friends had their diaries up-to-date. Also, good communication including talking to people at different levels of the business. Curiosity, and asking what might seem a dumb question. And being able to multitask as you move from one part of the business to another.

GH: From the mundane tasks one minute to complex tasks the next?

MS: Yes. I had a quick meeting recently with the office manager on our coffee policy, then the next meeting was an Executive Risk Group talking to our Edinburgh office. You need to be able to wear many hats and switch them according to the decisions required.

GH: And hold many thoughts in your head at one time.

MS: I've had a bit of practice because I'm also a Mum and I have two daughters, so I have to move off what the kids are doing and on to the business every day. It's a skill you can learn.

GH: How do you prevent yourself spending all your time in the day-to-day operational issues and problems to focus more on the big picture strategies?

MS: That is the biggest challenge, not getting bogged down in the detail. I delegate where I can and I have excellent people around me, plus I try to block out time in my diary for thinking and the big picture. I also write a log of issues as I think of them, to revisit later when I have time. But I admit that more often than not, the thinking time gets interrupted. We all struggle with the right mix.

GH: Martin Currie is a global business within Legg Mason, so how does the Australian operation contribute to policies or innovations?

MS: Yes, we have offices in Melbourne, Singapore and Edinburgh, and each region has different regulations and legislation and we can't adopt everything here. Reece Birtles our CIO is on the Global Executive team and we share ideas and best practices. For example, we recently launched an Emerging Markets ETF here and with offices in this region, we can trade to 'equitise' ETF flows during our day while Edinburgh is asleep.

GH: What drove the strategic decision to launch Active ETFs in Australia, which is a relatively new listed product compared with the most-established Listed Investment Company structure?

MS: I admit it was a challenge when we started the Active ETF conversations with the different intricacies versus our established managed fund processes. It was a new way of doing things. The usual Legg Mason products gave us cash flow numbers once a day complete with application forms. ETFs are tradeable with flows in and out multiple times a day. It involved many conversations driven by BetaShares and Legg Mason. We've done the hard part early with RINC* and EINC* and it seems people want Active ETFs.

GH: I've personally had an investment in RINC since it was first launched, and the performance has been excellent with exposure to listed property and infrastructure in the last year. I see it's taken about $35 million. Is that considered a good result given it was launched at an ideal time?

MS: It was the first ETF we launched, and Active ETFs is a new structure. We've done a lot of marketing to develop more platform and adviser support, and we're pleased with progress.

GH: It's an open-ended ETF, so if someone invests a large amount at say 10.30am, would you look to do a transaction off the back of that?

MS: It's a decision for the portfolio managers. We have guides and ranges where we will deal out the exposure, so a significant flow might be invested immediately. We also must watch transaction costs such as brokerage and custodian fees, so it's better to deal a net amount than small pieces.

GH: The last 12 months with the Royal Commission and consequences for ASIC and APRA and the industry generally have been significant for anyone with compliance responsibilities. Has it changed your role much, and is there potential for increased scrutiny to go too far and stifle innovation?

MS: Certainly, compliance roles and functions have increased, but we have always focused on being transparent. The Royal Commission problems were caused by people not being transparent and not acting in the best interests of clients. Managing other people's money should never be taken lightly. As long as you stay true to the right principles, I

don't think innovation will be stifled. But there's certainly more compliance focus, also driven in Europe by MIFID II.

A few of us, including in the investment team, have completed the Australian Institute of Company Directors (AICD) course, to better understand what boards and management are supposed to do. Having done that course, I would not want to be a director, but we want better engagement and discussions with boards.

GH: What parts of the business potentially keep you awake at night? You mentioned technology earlier, there's plenty of scope for problems there.

MS: On technology, I ask a lot of dumb questions. I've been in this role for a little over 12 months, and the main thing I think about at night is whether I completed what was on my list and added it to tomorrow's list. But it doesn't keep me awake … ask me again in a year and it might have changed. Cybersecurity is an issue we're constantly watching, but I have a lot of support with the average tenure in our team at 14 years.

GH: Do you have any role models? I guess the highest-profile female COO in the world is Sheryl Sandberg at Facebook.

MS: She's played an important role, but rather than look up to a Facebook executive, I try to learn from leaders more generally. For example, Jacinda Ardern's ability to mix work and the rest of her life so seamlessly, showing empathy one moment while getting things done the next. As a COO, you must get things done, but in a people-focussed way.

GH: To what extent are you involved in investment management?

MS: I usually attend the morning meeting, if I'm not doing school drop offs – my husband does the school more often than me, part of the shift from what was once considered a classic female role. Investing is the heart of what we do so I want to hear the stock updates and discussions. I'm responsible for ESG and I help analysts keep on top of best practices. It's a big focus in both the Edinburgh and Melbourne teams. ESG is still evolving in the industry in general, and many of our conversations with companies focus on governance in particular. For an analyst, ESG is another factor to consider, and there are different levels of understanding across our business and the entire industry.

**The BetaShares Legg Mason Real Income Fund (ASX:RINC) and BetaShares Legg Mason Equity Income Fund (ASX:EINC) are managed by Martin Currie. The (unlisted) Legg Mason Martin Currie Real Income Fund won the 'Retirement and Income Focussed' category at the 2019 Money Management/Lonsec Fund Manager of the Year Awards.*

Adele Ferguson on 'Banking Bad' and weaving magic

13 August 2019

Adele Ferguson is one of Australia's most-awarded journalists, receiving eight Walkley awards including a Gold Walkley for her joint Fairfax Media and Four Corners Programme, Banking Bad. She has also won a Logie and was awarded an AM in 2019 for services to journalism. Her reports were influential in the calling of the Royal Commission into Financial Services, and her new book, Banking Bad, tells the story of "power imbalance, toxic culture and cover-ups".

GH: Is investigative journalism almost like a calling that comes with its own sacrifices?

AF: I suppose it is in a way although that sounds a bit corny but it's certainly not a nine-to-five job. It's something that is always with you. You're always taking calls, listening to people, looking for things. So yes, it is a bit of a calling.

GH: Including circumstances where you've come under some personal attack?

AF: Yes, when you're up against big corporations, whether it's banks or franchise organisations or whatever, you are bound to get retaliation. Sometimes it can be a bit dirty with smear campaigns or threats of advertising being pulled. They try to disparage what you've written and undermine the whistleblowers or the victims, all those sorts of things happen.

GH: And in the media industry, which has been under a financial strain for a long time, pulling advertising is a big issue, right?

AF: Yes, it can really hurt when it's millions of dollars and jobs are on the line, but my organisations have continued to back the stories.

GH: Your book is not just about the Royal Commission as it also gives the background on how banking reached the current point. There's the history of FoFA and the impact of various CEOs and executives at CBA and other banks. While the banks have paid heavily through remediation, do you feel there are individuals who've escaped lightly?

AF: Yes. Even with the Royal Commission, there were a number of executives who caused a lot of damage but had already left and they were never called by Hayne. It was the same as when I did the first Commonwealth Bank financial planning scandal story which came out in June 2013. Some individuals were culpable but they had moved on. Some were in really good positions in other institutions but they were never called to account by anyone.

GH: One of the uncomfortable sides of the Royal Commission was that relatively junior executives, such as Nicole Smith, we're beaten up day after day when she clearly felt she was

just following instructions and doing her job. Do you think the Royal Commission targeted that sort of person too much?

AF: Yes, the Royal Commission allowed the institutions to choose who they wanted to put up as a witness. So the institutions that put up the wrong people. At one stage, Kenneth Hayne or Rowena Orr said something like, “Why are you here? You are so inexperienced, you've only been there a few months.” The witness couldn't answer any of the questions. That was a problem. The Commission should have called the people they needed, including some who had already left.

GH: You're widely credited for the stories that led to the Royal Commission. Is there one that stands out in your mind that most shocked you?

AF: The life insurance scandal at CommInsure. It was about sick and dying people. It really had a much bigger impact. I know many of the stories are terrible, such as the devastating toll of financial planning on a lot of people. But when you're seeing people who are terminally ill being knocked back for payments based on some spurious legal definition, that was really confronting.

GH: In your book, you describe how a CBA executive, Peter Beck, said he was shocked that relatively small amounts for medical needs were regularly referred to legal department.

AF: Yes, that really shocked me too. I remember a case, Noel Stevens was a scaffolder who had virtually no money to his name, maybe $10,000. He didn't own a home, he was renting. He got a phone call from a teller at Commonwealth Bank trying to cross sell. They saw he didn't have anything except a Westpac life insurance policy. So the teller referred him to a financial planner and they swapped him out of the Westpac life insurance policy into CommInsure, and said it was better, etc.

A few months later, he was diagnosed with pancreatic cancer and his claim was knocked back. He ended up fighting although he had only six months to live. He won the case and a few days later, he died. And the bank then fought it again and went to appeal. This was over about $300,000, and they even lost the appeal. It cost them about $500,000 in legal fees over a $300,000 claim that they had to pay anyway.

They go after little claims and they go hard because most people just give up.

GH: Can I put another side to you. When I was at Colonial First State before I left in 2012, which was relatively early in the remediation process, we felt that among the legitimate claims were people who saw an opportunity for ambit claims. They lost money during the GFC and this was a chance to recover it.

Do you accept that in this entire process, there are investors, the clients, who knew exactly what they were doing and now they're being remediated?

AF: No question, of course, there are always chancers who try to exploit something, which is a real shame, because it tends to sully what happened to people who were genuinely ripped off or put into inappropriate products. I get emails every day from people. Some claim forgery or fraud or doctoring of this or that document, but when I look at the claims, they just don't stack up.

Someone sent me an SMS recently saying, “Will you weave your magic?”

GH: Okay, they're trying to get you to become part of their lobbying.

AF: That's right. Or they'll copy me in emails to a bank CEO thinking that's going to do something. So yes, it certainly happens, I'm very much aware of it.

GH: While I was watching the Royal Commission, I felt frustrated that some senior bankers were simply answering yes or no and avoiding any explanations. I've subsequently talked to a witness who was told by his QC to say as little as possible. Do you think bank executives didn't do enough to explain their actions and justify better what the banks had done?

AF: It changed during the Royal Commission. The turning point was with AMP when Jack Regan got up. He essentially said AMP had lied 20 times. After that point, the QCs trained executives to be a lot more careful with what they were saying. It became yes or no and it didn't have a good impact.

GH: Yes. I felt as someone with a banking background, they should have explained better why they made certain decisions, but they were not prepared to.

AF: That's right. They were told to protect the institution and don't give anything away. They'll trick you. They'll do whatever. People were too careful.

GH: Most Australians, particularly as they approach retirement, need financial advice. But we now have thousands of advisers leaving the industry and the banks stepping back from advice. And most people are not prepared to pay enough for financial advice. Have you formed a view on how financial advice might be made available to the masses, other than the high net worths who will pay for it?

AF: I think financial advice is so important. People need good financial advisers but the industry needs to be professionalised. There were too many people that just did a two-week course. And then their remuneration relied heavily on commissions. Maybe advice should be a tax deduction to make it available to more people.

GH: Would you like to see a different business model that allows the banks to stay in financial advice, because that's still the place where people go for financial services?

AF: The banks needed to be more transparent. People would go to Financial Wisdom or Meridian Wealth and think they were getting independent advice. But the approved product list was stacked towards the parent institution, so it was deceptive. If you go to Mercedes Benz, you know you’re buying a Mercedes Benz. You're not told, “I'm going to give you the best car that is suited to you.” If banks were more transparent about the products, it might work better.

GH: What were some of the shortcomings of the Royal Commission?

AF: One of them is a chapter in the book, about a new whistleblower who has come forward on NAB and its cosy relationship with its auditor. It's a global issue with the role of external auditors and their dual role as consultants and how independent they are. The ex-Chairman of ASIC is talking about the global decline in the quality of auditing. The Big

Four auditing firms globally have been loss-leading on audit to get the lucrative consulting. It's causing problems when you look at the so-called independent reports by auditors on some big issues. Over the last decade, we estimate the Big Four audit firms were paid a billion dollars by the major banks.

The other thing I found disappointing with the Commission was that these issues are about the victims. People who've been ripped off, but the remediation schemes have all been different. Some have worked and some haven't. They've lacked transparency on the criteria they're using. The Royal Commission could have delivered a 'gold-plated template', a roadmap to follow.

GH: Did the industry funds come off lightly?

AF: Yes, they did. While the Commission went for 12 months, they spent only two weeks on the $2.8 trillion super industry. The Productivity Commission Report showed huge problems with performance figures, multiple accounts and other things. And to spend only two weeks looking at retail funds then spend so much time on NAB was wrong. Day after day with one person. It was just crazy, and industry funds hardly got looked at.

GH: Are you aware of anything that the industry funds are vulnerable on?

AF: The Commission should have looked at the role of the unions and the issue of slush funds needs to be put to rest.

GH: One of the headlines from the Royal Commission was 'charging fees to dead people'. It's become a catchphrase. But if you think about the legal profession, the very people running the Royal Commission, they rely heavily on charging fees to dead people. That's what estates and wills are about. Why did nobody from the banks say a financial adviser has a lot of work to do on an estate of a dead person?

AF: Yes, it was a great headline, but far more important was the 'fee for no service' they were charging to the living. The fees to dead people was really a headline that the media got hold of. But behind the fees were some tricks, such as claiming it was administrative errors when in fact it was deliberate.

GH: What do you hope is the dominant message that readers will take from your book?

AF: To stand up and be heard, not sit in silence as people did for years. Just speak up on wrongdoing, because if you catch it early, it doesn't blow up into something really bad. For customers, speak up because it could be fixed instead of destroying your lives.

One other thing on independent financial advisers. There needs more capital behind them. At the moment, at least if you get ripped off by a bank, they have deep pockets. The small fly-by-nights, they don't have enough capital, and that needs to be fixed by being part of a larger-capitalised group.

GH: That's another example of the failure of large institutions to sell their advantages. Let's face it, on the fee for no service issue, it would not have been too difficult to offer services like monthly reporting and a mandated annual meeting with your clients. It would have saved billions in compensation.

AF: It seemed so lazy. Even with FoFA, they didn't want to send out a document for a once a year opt in. Was that really too arduous for them? They brought it on themselves and would not take the reforms on board. When Matthew Rowe and Mark Rantall of the FPA (Financial Planning Association) said enough is enough, they were poorly treated by CBA.

GH: There are parts of the book where you describe an event but don't name the person involved. Why was that?

AF: I took the names out in places. I didn't think it added to the story, but people know who they are.

Adele Ferguson's book, 'Banking Bad', is available now.

Alex Vynokur on how ETFs disrupted investing

20 August 2019

Alex Vynokur is Chief Executive Officer of BetaShares Capital, an Australian provider of Exchange-Traded Funds (ETFs).

GH: What was the ETF market in Australia like when you first started?

AV: We launched our first product in December 2010. We spent a lot of time explaining what an ETF actually is. Many Australian advisers, and certainly most self-directed investors, thought we were talking about electronic funds transfer. A lot of heavy lifting had to be done early. We also had to build trust in a new business and trust is something that takes a lifetime to build.

GH: What was the size of the existing ETF market at the time?

AV: I'd say about $10 billion, and now it's over $50 billion, so it's come a long way.

GH: You decided from the start that you had to spend a lot of money and resources on education.

AV: Our view is that making investors more informed makes them more confident. Whether that's trust or knowledge, education is critical. You must be a key participant in the market. Once the market exists and is thriving, it is easier for new participants to come in and launch niche products and benefit from the growth of the industry. But if you want to be an industry leader, you need to lead on education.

GH: Can you remember the business plan when you started, and what you forecast at the three- or five-year milestone?

AV: The three-year milestone was definitely not met, but we have been surpassing milestones since. More importantly, more than half of all financial advisers in Australia have adopted ETFs as part of their investment process versus well under 10% when we started. We're also seeing self-directed investors, SMSFs in particular, gain familiarity with ETFs. The message of both indexing and ETFs is translating into strong flows.

GH: We were slow out of the blocks with ETFs. Even now, while something like 35% of the US funds market is in index investing, it's about 15% in Australia. Is there something about Australian financial advisers and their use of active managers that has contributed to that?

AV: Yes. Historically, ETFs didn't have a level playing field here. ETFs never paid commissions to advisers and pre-FoFA, the adviser business model relied on receiving commissions via platforms. Only active managers were recommended. Since FoFA and the stronger interpretation by the Royal Commission, we now have a level playing field.

But I'm not an indexing zealot that believes the whole world should move to indexing. And what constitutes an index is being redefined to include smart beta, variants on factor-based indexes and thematic indexes. In fact, thematic is becoming a substitute for individual stock picking.

I believe the funds management industry is going through the most fundamental period of disruption that we've seen in 100 years.

GH: Including a lot of fund managers closing.

AV: Yes, similar to music, media, print. Those industries have gone through tough times. Spotify brought havoc to an industry that was cosy and comfortable for a long time and the funds management industry is going through its own Spotify moment. Some fund managers will emerge stronger but a lot are hurting.

GH: You as an individual and BetaShares generally have supported both active and passive investing. When you meet with a financial adviser, how do you reconcile supporting both?

AV: Yes, I believe in the coexistence of active and passive. I also believe that when 75% of active managers consistently underperform the benchmark over 1, 3, 5 or 10 years that, where a recommendation is on merit and in the best interests of the client, ETFs will do well and their growth will continue for at least for the next decade or two.

Funds management is bifurcating. The days of actively-managed funds which are actually index huggers are numbered. They face extinction. Market returns or beta will be priced at index fund fees. Those delivering outperformance or alpha have a strong incentive to deliver that alpha and not hug the index.

There's been a lot of beta dressed up as alpha historically, and ETFs are clarifying the conversations. Clients are allocating a significant portion of their portfolio to a core for beta and indexing. Those advisers or clients who are searching for alpha must make allocations to higher conviction, active strategies. These days, there's nowhere to hide and managers need to justify their fees.

GH: In the last year or so, a major competitor of ETFs, the Listed Investment Company (LIC) structure, has experienced some problems. The majority of LICs, especially in equities, are trading at a discount to NTA, with some quality managers at 10 or 15% discounts. Plus there's criticism that they still pay commissions as a way to circumvent FoFA. In that environment, has the experience with active ETFs been as successful as you hoped? The fund balances don't seem high enough to me.

AV: I think it's going pretty well. But on LICs, while active will thrive alongside passive but in a different equilibrium, I do believe that delivering strategies using an open-ended ETF is a more honest way rather than locking up money in a closed-ended vehicle. Investors cannot redeem LICs at fair value. Asset management is a business of trust with the client, first and foremost. All managers' future prosperity must align with the wellbeing of the clients. The client should be able to take their money at fair value. While this is a generalisation, the interest of the fund manager in securing permanent capital is often at odds with the interest of the investor.

The renaissance of LICs over the last few years was not just about the managers seeking permanent capital. It was also parts of the adviser community struggling to wean themselves off commissions. That conversation will play itself out over the coming months.

But I do accept with a LIC there is a legitimate use to hold assets which are not themselves liquid. ETFs are fantastic at delivering true to label returns for asset classes which are themselves liquid. If the asset is inherently illiquid, such as physical infrastructure, you cannot place a toll road in an ETF because we benchmark against having 100% of our assets redeemed on any given day.

But I take a critical view of regulatory arbitrage and bypassing the spirit of the regulation with strategies which are perfectly manageable in an open-ended vehicle

GH: Do investors understand active strategies within ETFs, not only the indexed versions?

AV: We have a world of changing consumer preferences. The old days of downloading a 50-page PDF, printing an application form, scanning it and sending it back to the fund manager - that user experience is outdated. The experience of owning an ETF, active or passive, is far superior, and investors would much rather have all their investments housed alongside their direct shares. That's a big part of the growth of active ETFs and the user experience will continue evolving.

I see a day where the distinction between listed and unlisted funds is lost and it will be all about the user experience. Transparent pricing, ability to buy and sell at any time, availability across platforms, index supplemented by quality active offerings.

GH: How do you choose a new ETF? BetaShares now has more than 50, and at the time of launch, I've wondered about demand for some of them.

AV: We start with the needs of clients, and they vary significantly. Australia has a large retirement savings pool with investors both young and old. Risk appetites vary tremendously. Also, a portion of the market takes advice from financial planners and full service brokers, while a significant

portion is completely self-directed. Our product range includes core building blocks for portfolios across many asset classes. And at the same time, you'll see products which are more satellite or tactical, such as global thematics, cyber security, agricultural, healthcare. The Australian exchange is highly concentrated in financials and materials and we need funds for greater diversification.

GH: And fixed interest availability has undergone massive change in the last couple of years.

AV: Yes, cost-effective access through ETFs has become good. Traditionally, investors shied away from fixed income in the Australian market because it's was more complicated to understand and hard to access. And in the past, most superannuation investors were young accumulators. You could get away with a heavy equities portfolio because you had the time horizon to ride out the storm.

Today, the superannuation cohort is approaching or at retirement and issues such as sequencing risk and volatility affect how people sleep at night. The term deposit is good at preserving capital but there is not the negative correlation of different types of bonds versus equities.

GH: And in specific equity segments. I remember talking at conferences when NDQ (the NASDAQ100 ETF) was launched as a way to invest in Facebook, Google, Microsoft, Apple, etc on the ASX. It was launched a few years ago at $10 and it’s now $19, right?

AV: We believe the story of technology is long term and an allocation to the NASDAQ100 is sensible. But we also know investors cannot always rely on the sunny days of equity returns. If you had said three years ago that the top funds for flows would be fixed income, you would have been laughed out of the room.

GH: Of the 50+ ETFs you have, can you identify one that's done a lot better than you expected and that you're particularly proud of, but also one that you're disappointed with?

AV: Let me reflect on that (*long pause*). The cash ETF (ASX:AAA) has seen a level of adoption that has surpassed what we thought might be possible. A lot of people say they just leave cash in AAA. It's very humbling. We were aware of the opportunity on platforms because they were well known for not being generous on cash balances.

GH: Yes, and there's been more said about that in the media recently where platforms pay poor rates or nothing on cash.

AV: One that's surprised on the downside for us is the RAFI (fundamental indexing) product based on smart beta methodology. It’s done okay, close to $300 million in assets, so not a poor performer, but we expected a greater level of adoption.

GH: We see ETFs close in Australia sometimes, although none by BetaShares. Do you have a critical mass target or something that says a fund is not worth doing any more?

AV: We always think about our range and we have good economies of scale with $8 billion under management. We take a long-term view rather than looking for quick wins. I don’t see closing products as negative but more a sign of a maturing industry. Traditional managed funds open and close regularly, it’s accepted as the norm. We don’t feel a need to close any of our funds. There have been instances, such as with our gold ETF, where there was little interest for years and nobody wanted to talk about gold. Then suddenly, over the last six months, there’s more activity than we’ve seen before.

GH: Can we turn to the recent ASIC announcement on pausing the issue of new actively-managed ETFs. To quote:

“ASIC has requested that exchange market operators do not admit any managed funds that do not disclose their portfolio holdings daily and have internal market makers while it undertakes a review during the remainder of this calendar year.”

What is the issue here?

AV: Traditional ETFs which follow an index disclose their portfolio every day to allow market makers to buy or sell units on the exchange. But active ETF managers are concerned about protection of the intellectual property in their portfolios and want delayed transparency. This concept has been accepted globally. In some parts of the world, a model sometimes referred to as the ‘Canadian model’ allows the investment manager to disclose the components of the portfolio to market makers provided they sign a confidentiality agreement. They are then able to make a market in the same way as a traditional index ETF.

The ‘Australian model’ is where only one market maker undertakes the role and it is the same entity as the investment manager and the responsible entity. In other instances, such as with BetaShares which is not the investment manager, we partner with active managers and market makers so there is some separation. Our view is that the ‘Canadian model’ has merit. The existing model here is workable but can be improved with disclosure to multiple market makers.

GH: What is ASIC’s concern? How might an investor be disadvantaged when the investment manager and market maker are the same?

AV: ASIC will look at potential conflicts, for example, the market maker may have an incentive to set spreads or otherwise transact for its own benefit rather than the investment fund. With our active funds, we are not the investment manager and use an agent broker to conduct market making. We have no incentive other than ensuring investors are treated fairly. This is a matter of seeing if the framework can be improved. It’s a complex issue but we like a model where active ETFs and passive ETFs have market making done the same way.

GH: Last question. Australian ETFs are now over $50 billion. Where will they be in five years?

AV: Close to $150 billion, maybe in seven years as opposed to five.

Magellan's Vihari Ross on the players in the team

28 August 2019

Vihari Ross is Head of Research at Magellan Asset Management and a member of Magellan's Investment Committee.

GH: You joined Magellan in 2007. What's the same and what's different over 12 years?

VR: So much is still the same, perhaps because many of us are still here. The big difference is that we have many more people.

GH: But not a massive change overall because the business is so scalable. You're still at only about 130 people.

VR: Yes, but a lot of the additions are outside the investment team. We have many more in sales, operations and corporate advisory that we didn't have at first.

As far as the investment team goes, I don't think Hamish ever intended to run a small business. We never wanted to be in a position where people would say that your performance isn't replicable because you've invested in small companies. We always had a focus on larger businesses and the investment process was set up very early in terms of what we wanted to do.

The focus on downside protection was part of the hiring process with Chris Mackay and Hamish meeting each person. I remember talking about the way I approached investing and they were bringing people in that had a consistent thought process. It was thinking about risk and the distribution of risk along a curve and we were followers of Warren Buffett with a focus on identifying quality businesses in the first instance.

GH: So you never bought into the contrarian approach to investing?

VR: No, we were looking for quality and we still are today. Completely unchanged. And, of course, the next piece is valuation. We built models and as much depth of work as we could. I started on financial stocks and I remember discovering a huge pool of FDIC (*Federal Deposit Insurance Corporation in the US*) data and it was all free. We were identifying opportunities and checking excruciating detail, including what makes a company a quality business. We have more resources now to access these external data sources.

GH: A lot of fund managers rely on broker reports.

VR: We don't use brokers to a great degree and we do our own work. That's why we have a team of 30 analysts, and each of them covers only six or eight stocks or less if a company is complicated. We try to get to the essence of what makes a company tick.

GH: Hamish has admitted to some mistakes, including Kraft and Tesco. What's the checking process then?

VR: When something goes wrong in a concentrated fund like ours, we spend a lot of time on the problem. With Tesco, the initial error was around business quality and the degree or intensity of competition from the rise of Aldi and Amazon. Eventually, the business turned around but the lesson is that we'd now be less willing to wait around because it was taking up space in the portfolio, or as we say, on the team. Hamish likes the analogy of each company in the portfolio being like the player in a team where each stock has to earn its place.

GH: What's the difference between managing $1 billion and managing $80 billion?

VR: Again, we're doing it in exactly the same way. We've never gone down the company size scale. We always had a focus on liquid, high quality companies trading at a reasonable price. We now have three traders and they are at the coalface of executing the management of the $80 billion.

GH: You must have companies that you like on every other parameter but you can't get enough money into the market to invest in the company.

VR: That's true but we've always had rules around liquidity, so that's not different. But yes, we do find emerging companies but if they are small and illiquid, we don't go there. We also want companies that already have an identifiable moat, not working on building one or where there are significant uncertainties and risk around whether they will make it.

GH: You wrote an article recently on the ways the world is changing and especially the projects Google is working on.

VR: Yes, each item I mentioned in the article related to a specific project that is underway. Alphabet's Loon project for hot air balloons intends to deliver wi-fi around the world to even the most remote locations, Verily is a long-term health project with an aim to extend human life, and Wing is their drone delivery service. Better known are Waymo, their automatic cars and DeepMind on AI. It's all part of Google's other bets. Many of these feed off Google's goal of extending the quality of life, not simply prolonging it.

GH: You also wrote that you may invest in companies where the economics are so good, you're less concerned by the quality of management.

VR: My point was that there are high quality companies that are sometimes not being run as well as they should be. For example, McDonald's between 2010 and 2013 was still a good business but it could have been run better. They ultimately fixed it and the underlying economics didn't deteriorate.

Let me answer this way. I mentioned moats, but we also look closely at business risk and the range of outcomes along a distribution curve. Is it a highly predictable, stable business, or is it consumer discretionary which is unpredictable in a recession? Or are there tail risks like Johnson & Johnson getting sued for the talc problem or BP on the oil disaster. Or Tencent, which makes 70% of its money out of online games,

facing a freeze when President Xi said gaming is bad for young minds. We focus on how predictable is this business and we need to build conviction. So that's business risk.

The third piece is agency risk. Are management good stewards of shareholder capital including governance and the right incentives, do they have a sensible acquisition strategy? So yes, sensible management is one of our pillars of quality and it's held us back from going into businesses in the past because we just can't get comfortable.

The last piece is what we call reinvestment potential, which is the company's ability to redeploy capital at high rates of return. Some businesses are fine, they don't need incremental capital to grow. It's wonderful. But some businesses like a utility can invest capital and also do well.

We've actually owned most of the things on our menu at different points in time. One we haven't owned is Richemont. It has an incredible brand in Cartier which makes up the bulk of its earnings. It makes 60-65% gross margins and generates strong returns on capital. However, there has been significant risk following the CCP corruption crackdowns in 2013 which materially impacted the watch component of its business and led to a less than rational response from competitors. This has led to a wide distribution and uncertainty about future outcomes. Ultimately, valuation as well as quality and our conviction around that will determine a stocks inclusion in portfolios.

GH: Your main global fund is already concentrated, but now you're launching a high conviction fund. What's the difference?

VR: We've run a conviction portfolio since about 2013, only 8 to 12 stocks, as a distillation of our very best ideas with more flexibility and less rules. For example, it can hold more cash and take more risk.

GH: It feels like it will be quite a ride.

VR: It will be, but deliberately so, and it's for investors who understand that. While it is more concentrated, there is diversification within the thematics of the fund, such as Visa versus Google versus Starbucks.

GH: Many people would consider the Magellan Global Fund is already concentrated with only 20 or so stocks.

VR: Well, maybe this is because I'm a Magellan person, but if you own too many stocks, you diversify your alpha (*extra returns*) away. Our whole process is about best ideas. Hamish always uses the analogy of a football or the cricket team. Every player must earn their place and each player has a role. Someone might be in the team because they can hit sixes, or give huge potential alpha but with more risk. But there's another with less risk who will bat through the innings. They have a wide moat with low disruption exposure and a fewer risks if things go wrong. They contribute to the fact that we always hold less portfolio risk than the market level.

GH: In the past, you have personally specialised in franchises, and some of them now have a bad name in Australia due to doubtful business practices. What makes a great franchise business?

VR: What we call franchises are essentially consumer franchises, and there are two key elements: brand and distribution. That's access to the consumer in one way or another. So it's Yum - which owns KFC and Taco Bell - obviously McDonald's and Starbucks. But we also include fast-moving consumer goods companies like Nestle and PepsiCo, it includes luxury goods and big box retail like Lowes.

But market positions are evolving. For example, historically, large consumer goods companies like Colgate, Procter & Gamble and Kellogg owned many great brands, advertised on nightly TV and then consumers would go to the supermarket which was the only place they bought groceries, and they bought their favourite brands. That reinforced their brand dominance. But now, a big theme is the rise of social media and online shopping. Social media enables challenger brands to come up and disrupt by gaining a following and taking market share and the big brands have in many cases been asleep at the wheel. It's a bit like Oracle saying 10 years ago that the cloud is a fad and now they are investing heavily.

GH: Like Dollar Shave Club initially being ignored by Gillette?

VR: Yes. All you need is an influencer with a million followers to start talking about you. I call them mushroom brands and not all make it but the ones that do are often genuinely good ideas. We focus on which are the truly resilient brands. In the UK, for example, half of all grocery sales are private label but it is a small proportion in the US because Walmart always sold top brands at lower prices. The big brands are squeezed but even more vulnerable is brand number four or five. There's a market leader, a challenger brand, a private label, and less and less room for marginal players.

GH: And tying up distribution as well.

VR: Yes, think of Louis Vuitton. Incredible brand but it also has its flagship stores, its beautiful stores in the best locations around the world and they don't sell their products anywhere else. You get the best customer service and you'll never receive a discount, which is important for brand equity when you're not selling through Nordstrom or Macy's or wherever at 80% off.

Starbucks is a great story of brand and distribution and a growth story with Chinese consumers. It's very difficult to disrupt, they will not be hit by technology, they will embrace it. Now they have a great app for ordering coffee so they keep adapting. Coffee delivery is becoming a big thing. Technology is actually an opportunity. You have to work out if a disruption is more a flesh wound or if it's really going to hurt a company.

GH: A couple of years ago when I would attend Hamish's presentations, there was a very strong interest rate theme. He quoted percentage possibilities of rates rising and possible impact on equity valuations. That seemed to his main concern. Is that history now?

VR: We still use that slide and going into the end of last year, our view was that risks were still skewed to the downside in terms of the potential impact of rising rates. QE was expected to unwind with four Fed fund rate rises over the course of the year. Unemployment was low and there was talk of inflationary risk. There were lots of reasons to hold cash, then January rolled around and the Fed suddenly says, "We're done."

GH: Magellan's Global Fund cash was as high as 20%.

VR: Yes, then in January this year we were in a different world. We changed our view on the probabilities. Where we thought the risk of inflation was 50/50, we were then more like 25% because the economy was still running hard and companies like McDonald's were saying they were experiencing cost pressure. But we changed our model.

GH: And that change included lower rates and generated higher equity prices?

VR: Yes, but not in a universal sense. We have redeployed a lot of that cash and we're back to around 10% cash. But the reasons for the Fed change also suggest lower growth as the Fed sees a need to keep the current level of stimulus there. What does that mean for some businesses? For some, it means lower growth as well. But we try to reconcile these positions because not all businesses will have lower growth. The way we've redeployed the cash is into defensive equities and not into cyclicals. For example, with consumer staples, their growth comes from people buying food, it's pretty stable.

But in a DCF (*discounted cash flow*) model, if you have a business that's economically sensitive, you might apply a lower discount rate but you've got lower cash flows as well. In a business that has a resilient earnings profile because it's a staple or has a huge structural growth tailwind behind it, you might apply a lower discount and the cash flow does not fall as much proportionally or at all. You will end up with a higher value in that situation. So it depends on the company whether the lower discount rate feeds into a higher valuation. It's important to not just blindly think everything's worth more.

GH: That's a really important valuation point.

VR: And remember, we're looking at a very privileged subset of companies. We're not looking at the battling retailer. Those guys aren't worth any more with a lower discount rate because they've got a lower growth rate.

It's surprising how resilient TV has been but I think that's next sector to be disrupted. People now watch news on YouTube or online but it's not some New Age thing. It's just the way we are all going about our lives. My son said to me recently, "We don't watch the news." And I said, "No, we read it online." There's nothing sinister going on there. It's just that it is easier to do it that way, and advertising dollars follow the eyeballs. It's as simple as that.

I consider health and wellness is another disruptive trend. People are living better and it has an adverse impact, for example, on the sales of breakfast cereals but it hasn't impacted the sales of chocolate or crisps because people still want a treat. The stuff that is part of people's daily rituals, you need to bring the health element into that. So we're looking for structural, resilient growth, like people drinking coffee every day. Will that continue for decades to come? I think so, we're not going to deny ourselves that.

GH: Last question. Do you feel strongly about a theme or trend which generally the market does not recognise?

VR: We are all about big structural trends, to identify them and be exposed to them and then benefit from the magic of compound interest. We've recently spent a lot of time on the Chinese consumer. While it might be well known, it's underappreciated. Everyone talks about the rise of the middle class, going from 300 million to 600 million over five years. But just as interesting, is the growth in the affluent class of Chinese consumers. Okay, we're only talking between 1% and 3% of the population, but the numbers are big.

And what are they doing? Drinking premium coffee, buying premium cosmetics, travelling overseas, staying in the best hotels, wearing high-end fashion, buying good Australian wine, cognac, Mercedes, BMWs. That cohort has been growing at 30% compound annually. It supersedes the demographic headwind of small families and slower population growth. The Chinese are moving up the income curve and there's a lot of disposable income. That's capitalism at work. It's entrepreneurial, capitalist and economics in a fully dynamic way.

Daniel Foggo on why P2P lending is not what you think

11 September 2019

Daniel Foggo is the Chief Executive Officer of RateSetter, Australia's largest peer-to-peer (P2P) platform, now commonly called marketplace lending.

GH: You're approaching your fifth anniversary. How has the peer-to-peer or marketplace lending business in Australia, and RateSetter, progressed versus your initial plan?

DF: Very much in line with our expectations. When we started, we believed we were building a structural alternative to the bank model. We were moving consumer loans from funding by bank deposits into a new investment class for investors and opening it up. From day one, we wanted a comprehensive reporting environment and to move away from a negative reporting environment to make sure that our credit performed.

GH: What's a negative reporting environment?

DF: It's when a consumer applies for a loan, the lender looks up the applicant's credit file to learn if they have previously defaulted. When we launched, the Australian credit bureaus didn't offer the granularity of information we wanted but that has now changed, and we have a much better ability to assess credit. The building blocks of the business have been around credit standards and we've funded almost $600 million of loans. The loss rate to date is under 1.8% of what we've funded.

GH: Is that of the number of loans or of the amount you have lent?

DF: Of the total amount. We offer granular risk-adjusted pricing to our borrowers and pleasingly our credit models have proven accurate in the rank order of losses. And the independent Provision Fund held in trust has covered every one of those losses and still represents about 6% of our loans outstanding on our retail book. Borrowers pay different amounts into the Provision Fund, depending on their credit characteristics.

We've had to build profile with both investors and borrowers. We obviously advertise and feature on comparison sites to attract customers, and we work with corporate partners. For example, we integrate with installers of renewable energy products and different battery, energy and solar panel companies for loans on our renewable energy lending markets. It's important to reach scale, especially finding ways to attract good borrowers.

GH: A lot of readers might think that a 'marketplace' is like eBay where anyone can put up an item for sale. What borrower checks do you perform?

DF: Well, we call ourselves a marketplace lender and we do operate several markets through which investors can access loans. However, the term maybe disguises the fact that in many respects we are a fund manager, only we are specifically focused on consumer credit. We think of ourselves as fund managers focused on consumer credit, and we need to ensure returns are reliable. Less than 10% of the people who want a loan from us will have it funded because we decline most people.

GH: I'm surprised it's so low.

DF: We decline loan applicants at different stages where they don't meet our credit criteria. About 40% of applicants don't even get through to our application form because they don't meet our initial criteria. Once people go through an application, they might be declined immediately based on some of the information they provide. Or they might get through to our underwriting team and get declined there.

GH: Why might someone get declined?

DF: Our loan underwriting process is not dissimilar to that performed by a bank or other traditional lenders. We collect information from the applicant and use third party information sources for form a view on their credit strength and the suitability of the loan they've applied for. We use the Government's document verification service to assist in our credit checks. We also check the applicant's credit file with a credit bureau. We typically require bank statements from the applicant to confirm identity, income, expenses and other debts. We go through all the usual processes that are required under the National Consumer Credit Protection Act 2009. Amongst other responsible lending obligations, we must ensure the loan will not place the borrower in financial hardship and that the loan is for a suitable purpose. For example, paying off a holiday over five years does not make sense.

The second component of making sure it's a sound investment option is how we price risk. We not only want to fund the right people, but we put aside enough money to cover expected future losses.

GH: How is the interest rate on a loan determined?

DF: The base funding rate is the same whether the client is an 'A' borrower or a 'B' borrower. What is different is how much the borrower pays into the Provision Fund. That may be a fee up front or part of their interest rate. So, Joe might borrow at 7% but Jim might pay 10%. Joe owns his own home and has a stable job, while Jim is a tenant who might change jobs more regularly. Joe might be paying 2% into the Provision Fund while Jim is paying 5% of the outstanding loan balance. It's representative of the risk.

However, the investor is receiving say 6% whether they are funding Joe or Jim, and both are protected from default by the Provision Fund.

GH: Let's focus on the Provision Fund, because not all marketplace businesses use them. If I'm an investor and my borrower places say 2% into the Provision Fund, if the loan defaults, I have access to the full 100% of my loan, not only the 2%, right?

DF: Yes, it's not just the amount your borrower puts in. Rather, you as an investor have the benefit of all the money paid into the Fund over the last five years. It delivers a diversification of credit risk and the Fund currently has $14 million in it. Our expected losses on loans outstanding are about $9 million, giving a 1.6 times coverage ratio.

GH: And that $9 million is based on your experience with the types of borrowers in your loan portfolio?

DF: Exactly. We analyse our loan book daily, not dissimilar to the way a bank forecasts expected losses. We have enough loss curve data to have a good understanding and we can quite accurately assess the loss rate. Clearly, if the economic environment changes, we need to take those things into consideration as well.

GH: Given your detailed lending process, what are some of the main reasons for defaults? What happens to people?

DF: It's generally a change in personal financial circumstances. In line with industry averages, about a quarter of losses are associated with some sort of bankruptcy. The remainder might be losing a job or health issues, but there's a diverse range of reasons.

GH: What's your process for chasing a default?

DF: We seek to cure loans in arrears for the first 45 days and we have a successful track record doing that. If a loan remains in arrears beyond this period, then we work with three different collections agencies to support our collections efforts. These agencies are regulated businesses and they operate on a contingency basis, and given our scale, we ensure there's competitive tension around their services.

GH: Which bank products are you replacing?

DF: The key trend is the decline in credit card usage. Card spending has remained stable but the balances where customers are paying interest have declined. People are looking for alternative ways to hold that sort of debt and personal loans are a good solution. Also, personal loan market share of the Big Four banks has fallen over recent years. Businesses like RateSetter have gained meaningful market share.

GH: How does it work for an investor if I want a strong borrower, a homeowner with good income, buying a solar

system for their house. What do I find out about the borrower? Can I know how much of their home they own or their income?

DF: We believe we're in a better position to understand the credit characteristics of the borrower than our investors. We've got more information available to us to price their credit risk. It includes information from a credit bureau that we can't pass on to an investor. That's why we think the model works better with us as a manager of consumer credit, where the investor relies on us to manage the risk, rather than the investor choosing the specific borrowers they want to back.

To gain the investor's trust, we do various things. We make sure we maintain a good track record, we are transparent by providing information to our investors and we have the Provision Fund. If we relied on the marketplace model by saying, "You go away and assess that credit and make a judgment", we don't think that model would work very well. Most investors are not experts in credit, nor do they know how to minimise risks appropriate to them.

Investors don't see a lot of information about the borrowers they have funded. However, every quarter, we upload our whole loan book onto our website so investors can see every loan we've funded. We include information on the age of customers, the credit bands and whether they are homeowners.

GH: Tell us about the characteristics of your investors, including SMSFs?

DF: Sure, there's a great diversity. SMSFs represent about 20% of our retail lending by funded amount and it continues to grow. The average amount invested by an SMSF is about $90,000.

GH: That's significantly more than I expected.

DF: Yes, whereas the typical non-super retail investor averages about $20,000 and that's where most funding comes from. Our investors are typically aged 45 and over and investing in our five-year, higher-rate markets, looking for yield outside of super. But that masks a lot of relatively young investors who are investing smaller amounts. About 75% of our investors are male.

GH: And what about institutions?

DF: We were delighted to introduce Future Super, the leading fossil-free superannuation fund, to our investor base last month. We also have the support of some fixed income funds, some financial advisers who have put their clients in. The Government's Clean Energy Finance Corporation invests alongside other investors in the renewable energy lending markets. We went through 12 months of due diligence to get them comfortable with our business model and underwriting process. Plus, we have a small number of ADIs (*Authorised Deposit-taking Institutions*).

Our investors are looking for strong fixed income returns, and our investor surveys show over 80% have shifted money from term deposits or savings accounts into their RateSetter account. We often describe RateSetter as offering an attractive middle ground between the safety of deposits with a government guarantee and equities which can be more volatile.

GH: How to you respond to arguments that marketplace lending has not been through a recession in Australia?

DF: We are funding the same borrowers who in the past would have borrowed from a bank. We have not found a new class of borrowers so there's no reason our borrower loans will perform in a materially-different manner in a recession. In fact, our losses are less than large banks typically experience on 'new-to-bank' customers, which are typically around 6%. This is because our checks are more vigorous and our loss rates are around half that level.

Also, the asset class we're investing in is highly resilient. Australia has not had a recession in the last 20 years but if you look at credit performance in the UK and the US during the financial crisis, consumer credit outperformed small business credit, large business credit, property lending and even in the US, mortgage lending.

The other component of our asset resilience is our short duration loans, averaging a little over three years. Plus, we have the Provision Fund.

GH: Do you think there is a general preconception in the market that your borrowers are people who can't borrow elsewhere?

DF: It depends how much time people have spent looking at us and our history. Investors just need to go to the statistics page on our website to understand the type of borrowers we fund. There are two types of people who come to us: those who can't get finance elsewhere and those who come to us for a better deal. It's the latter type we're good at tapping into.

Over 2,000 borrowers have reviewed our offering on Product Preview and it gives a sense of the type of people we lend to and what they care about. These are not people who couldn't get financing elsewhere. They're refinancing their credit card or improving their kitchen.

GH: Can you explain what people do with the money, especially the green and automotive loans and what some new areas might be.

DF: We're looking after good credit customers through their life cycle. When they are relatively young, they might need a small loan for a holiday or wedding, for example. When further along in life and applying for a mortgage, they might want to improve their financial situation by consolidating their credit cards into lower monthly cash flows. After they buy their home, they might refurbish the kitchen. About 60% of people who buy a new home then buy a new car in the next 12 months. Then they might send their kids to private school.

About 40% of our customers are looking for a better value alternative to existing finance and that's most commonly credit card debt. The next most common is automotive finance and the third is home improvement. Then there's a long tail of reasons such as weddings, holidays, medical. We want a diversity of terms, purposes, geography.

A growth area is that more people care about the environment and they want solar panels and maybe a battery. When we think about the future, we want to have an impact on electric vehicle finance, because with it brings together our experience in renewables and automotive finance.

GH: Finally, what do you think of this confusion of names, such as peer-to-peer lending and marketplace lending?

DF: It's a misnomer in many ways. We're more akin to fund managers. It's taken us time to realise that in many ways. We live and die by credit performance.

We are giving people access to an asset class, and a key competitive advantage of ours is not being reliant on wholesale funding lines that can come and go. We've had record numbers of investors sign up each of the last three months, and undoubtably low interest rates are one of the reasons behind that. They are placing investments with a fund manager.

Vanguard's Frank Kolimago on democratising investing

25 September 2019

Frank Kolimago is Managing Director of Vanguard Australia. Previously, he was Principal at Vanguard's Personal Advisor Services. He has been with Vanguard for 23 years.

GH: Many of our readers would be unsure what Vanguard's 'mutual' structure means, and how it influences your business decisions. Could you explain it, please?

FK: Vanguard has a unique ownership model that goes back to our founding in 1975 by Jack Bogle. A typical asset management firm is either owned by public shareholders or privately by a family office or individuals. Vanguard is owned by our mutual funds and ETFs which are in turn owned by the investors in those funds in the US. Jack Bogle believed it was a better way to align the interests of the firm with investors rather than having a tension where business decisions are made on behalf of outside owners versus investors. We have a clearer client alignment.

GH: Can you give an example of how it might influence your decision-making compared with say a listed company?

FK: The biggest proof point is the fund and ETF expense ratios have declined through history. Our weighted average expense ratio is now about 10 basis points (0.10%) for close to A$7 trillion of investments globally. In Australia, we've had a history of delivering fee cuts. The bigger Vanguard gets, the more we look to pass economies of scale to our investors. At the same time, it's not just about low cost, we want to deliver a world-class service experience.

GH: At your recent 10th anniversary of ETFs in Australia, you talked about 'democratising investing'. What does that mean?

FK: Democratising is giving investors the best chance of success. ETFs are a good example because they require low minimums to invest and at a low fee. A retail investor can get global diversification in a single trade. A few decades ago, such a solution was only available to an institutional pension fund. Now, mom and pop investors get the same benefits.

GH: Given Jack Bogle's pioneering role in index investing, how do you reconcile that with offering active funds?

FK: When Vanguard was established in 1975, our initial suite of investments was 11 actively-managed funds. So while the growth of indexing has commanded a lot of attention in recent years, active has always been an important complement. Vanguard manages about US$1.5 trillion in active strategies, or about 25% of our global investment base.

We think of it as a low-cost investing philosophy as opposed to a binary active versus passive choice. Some investors see the benefits of active to seek outperformance, but also an appreciation that active can have periods of underperformance. That's part of that trade off.

We also use 'sub advisory' (*Ed, external fund managers*) relationships when we think they have talent and a track record in their processes and philosophies. We partner with them and they get access to our broad distribution. Vanguard also runs portfolios in-house, for example, on the fixed income side. So it's not a source of any inner turmoil and we've been both active and passive throughout our history.

GH: Why hasn't Vanguard joined the move into active ETFs in Australia?

FK: Well, a technical point is we do have three active ETFs in Australia, in the form of 'factor-based' ETFs. We have a value-oriented, a minimum volatility and multifactors. It's a more quantitative approach but technically it's active.

In our product development agenda in the 23 years we've been in Australia, our roots were passive and managed funds in the first decade. In the second decade, we've built out the ETFs with newer structures, like ESG, in both ETF and managed funds forms. We don't rule out more active ETFs over time.

GH: Can you explain how you manage a global fund during the Australian time zone, where the underlying investments are not traded here but you issue and redeem ETFs during the Australian trading day?

FK: We have three trading hubs. One based in Melbourne, one in London and one in our headquarters in suburban Philadelphia, a town called Malvern. They give capabilities in the major regions when markets are open. The trading day begins in Australia, covering Asia Pac, then we hand off to our teams in the UK, and they pass positions to North America. We have the same processes, the same systems, the same structures, in those three markets as we 'follow the sun'.

GH: What happens if, say, a global fund owns Apple, Microsoft, Google, etc., which are not trading in this time zone?

FK: The pricing intraday on the local exchange is done by market makers who cover our ETF lineup, including global funds. Each day, Vanguard advises the market makers of the basket of securities used to price each ETF. The market

makers take the end of day Net Asset Value (NAV) in US dollars after the US market closes. At the start of the day in Australia, the market maker converts that US NAV into Aussie dollars at the current spot prices. From there, they adjust the value of the underlying securities using the movement of S&P500 futures which trades 24 hours a day. The market maker posts bids and offers throughout the Aussie trading day.

GH: So there are traders during the Australian and Asian day who are trading S&P500 futures, and the market makers do not trade in the individual stocks in the ETF?

FK: Yes, S&P500 futures is highly liquid and market makers have all the trading automated, and they make their money on the bid and offer spread. They may use other hedging techniques. We want to see our products at tight spreads with lots of liquidity so we encourage competition. The mom and pop retail investors coming in and out of our ETFs don't need to be concerned about the hedging complexity.

GH: One of your Australian team told me he used to work for an investment bank on Wall Street, and he said it's a relief to work in the Australian operation of Vanguard. You have worked in many places around the world, do you see cultural differences between these locations?

FK: I've worked in four locations with Vanguard: Japan and Australia outside the US plus domestic sites at our headquarters plus our Western Region Service Centre in Phoenix, Arizona. I'm always amazed by the level of consistency in culture across Vanguard. When I started, we had about 2,000 crew members back in 1996. Today, there are over 18,000.

You need to maintain that culture. It's in the way we recruit, the way we onboard, the things we reinforce, client-focused alignment, a strong focus on ethics and values. The strong level of consistency includes things like respect and collaboration. But whether you're in Malvern, Pennsylvania, or Melbourne, Australia, it essentially feels like the same organisation.

GH: And what do you think about the differences between investment banking cultures and Vanguard?

FK: We sometimes use the phrase in the US, 'Wall Street sophistication with Main Street values' I'm not sure if that resonates with Australians, but we make sure of our ability to handle complexity while old-fashioned ways of doing things shouldn't go out of style.

GH: You ran the Vanguard Personal Advisor business in the US. I'm not sure what generic term you call it such as robo-advice or digital investing, but can you explain how that model works.

FK: Sure, we're excited about Personal Advisor. Vanguard had a legacy advice business dating back over 20 years. It was a traditional model with a human adviser but essentially telephone-based built in the early days of the internet. It was a bit of a niche offering, but then we saw rising demand from our clients. Many had built their wealth in a do-it-yourself capacity and they were asking for high-quality, affordable advice. The big driver was demographic, an ageing population with lots of wealth. Vanguard was helping with low-fee investing and education and guidance, but clients were facing more complex retirement decisions. Like do I have enough to retire? How do I preserve my assets? Will they last over a long retirement? How do I cover health care costs at the back end?

Based on that need, we researched how could we scale to meet the demand in a way that would be affordable with a high-quality interaction. We settled on a hybrid model that sits in the middle with robo-like technology but a human adviser is a key component. We call it a hybrid, which is not as glamorous as robo, but it now has about US$145 billion under management since May 2015. The interaction is virtual, telephone and video-based with an adviser who participates. We have a couple of interactions upfront to do the consultation, the collecting of the information, then there's a structuring of a plan for the client. If the client accepts that plan, they get enrolled, and then they have an ongoing relationship with the adviser.

A lot of the focus has been on the pre- and in-retirement audience, with 85% of the clients aged 50 and older and half are over 65. It costs 30 basis points (0.3%) for ongoing advisory, and the weighted average investment cost is under 10 basis points (0.1%). So it's advice plus investment with a human adviser and great technology when the traditional price for advisory fees alone in the US was over 1%.

GH: Does a client ring up a call centre and talk to whoever answers the phone, or do they receive a more personal relationship that develops over time?

FK: The initial engagement would probably start with the website, although they could consult with one of our contact centre reps. They would be directed to licensed advisers who have CFP and specialised skills. We use a team-based model for US$50,000 up to half a million but at US$500,000 and above, clients work continuously with the same dedicated adviser who brought them onboard.

GH: US$145 billion in four years is an extraordinary number in an Australian context. How much is new and how much came from other parts of Vanguard?

FK: The majority has come from existing Vanguard clients, but often they consolidate assets from outside of Vanguard, taking more into an advisory capacity. In the US, people have employer-sponsored 401k funds and they often roll them into the relationship. Our mutual model is dedicated to improving our capacity with existing clients and we have built our team to 775 advisers.

GH: It sounds like the only business model that will work for mass market in Australia under the new rules. What's the possibility of a rollout here?

FK: It's not in our current near-term plans. Our focus is on upgrading and modernising our current retail business and enhancing its digital capabilities. It will create a foundation to extend the business over time. Technology and our learnings mean we can do things in a more cost-effective manner than in the past.

GH: Last question, Frank. Can you see any global trends either in investing or advice that will materially impact Vanguard business over, say, the next decade?

FK: Sure. Here are a few 'lightning rounds'.

First, the accelerating pace of technology and the future without work or the future of work. Will technology automate

work to a degree that will displace workers? And what will happen to portfolio management and financial advice? We think technology will help to automate many routine tasks. We already have portfolio construction and rebalancing and the creation of financial plans that's highly automated. But it gives the adviser more time to be more creative, more empathetic, and to invest more time in the relationship management. We don't think that technology will take humans out of the mix but they will focus more on a higher-order type work. We need to train people to have more of those 'soft' skills.

Second, the continued pressure on fees and the low-cost revolution. We've seen it on the investment product side, and we'll see it in other forms of financial services such as advice. We all need to embrace it, it's not something you can fight against, it's something that is inevitable. And developing business models that are efficient and cost effective where the value flows back to the client.

And the last thing is demographics and longevity. People retire, maybe in their mid-60s, and one member of a traditional couple could be looking at a further lifespan of 30 to 35 years. How do we structure portfolios that recognise such longevity? How do we help people who are doing different things over those decades? In the US, 10,000 Baby Boomers retire every day and we need to see that age wave coming and position ourselves to provide the best services and solutions.

Elizabeth Bryan and Chris Cuffe on how good boards work

9 October 2019

On 22 August 2019, as part of its Professional Series, financial advice firm Stanford Brown hosted several experienced directors presenting their insights on how a company board should perform, with hints for prospective board members.

Elizabeth Bryan was the first woman to run a large financial institution in Australia at State Super from 1992. She is currently the Chair of Virgin Australia and Insurance Australia Group and a member of many government panels.

Chris Cuffe took Colonial First State from a start up to become Australia's largest investment manager during his 14-year tenure as CEO. He is now chair or director of several companies, including Australian Philanthropic Services. Chris worked with Elizabeth on the board of Unisuper, succeeding her as Chair in 2011.

The discussion was hosted by Vincent O'Neill, Director of Private Wealth at Stanford Brown. This is an edited transcript.

VO: The reverberations are still being felt from the recently-completed Hayne Royal Commission. Elizabeth, can I ask you about the changing roles and responsibilities of directors.

EB: The duties of directors pre-Hayne and post-Hayne have not changed. The duties of directors are to the company in perpetuity. At the beginning of his report, Hayne emphasised the values that should guide Corporate Australia. They are simple values about fairness, trust, transparency, obeying the law, doing the right thing. Nothing very complicated. They are the core values that reside in our society. In the complexities of some of the big financial companies, he felt that these values had become lost, leading to some the egregious situations outlined in his report.

There is, however, a gradual change in society's expectations of big companies. Businesses provide many of the essential services of our society and people expect to be dealt with in a certain way. Customers don't want complexity, they want fair, honest and reasonable dealings with these big organisations.

And so the directors' job has changed because of high social expectations about what society wants from these large companies. And that's what you read about in the papers.

VO: Do you think there's been an awakening among directors of how expectations are changing?

EB: The perception that directors are either bad or asleep is not correct. Most directors of Australian companies are diligent, smart, hard-working people, and they do the best they can. But the expectation has shifted from maximising shareholders' funds to serving the needs of various stakeholders. And that's a big change.

VO: Can we focus on the transition from management into board life by exploring some of the motivations behind the move, and perhaps some words of caution.

CC: There are many motivations. Some people do it for the money, some for the power, and some to remain relevant. Not everyone wants to play golf all day at the end of their executive career. Some want to maintain contacts and networks. There's also a bunch of people, and I am one of them, who feel they have accumulated knowledge in a particular domain and we feel we can share that knowledge with other groups.

It's important to understand what your motivation is, but to be a director simply for the sake of being a director is not good. Some people treat being the director of a listed company as a trophy, but believe me, there are many obligations and responsibilities, and it can even be a bit scary.

VO: Elizabeth, what continues to motivate you in particular roles?

EB: It's important to consider what organisations do. I think I've got some frustrated public service policy role in me. I think companies in essential public services are worthwhile, so we put the hard work into getting them right. That's where I get my pleasure from.

VO: Many people serve on charitable boards. Is that a steppingstone to other professional boards?

EB: I'm not as experienced as Chris on charity boards, but as chair of a company, if somebody is brought to me for a non-executive director (NED) role, their participation on a charity board is of no consequence.

I'm looking for two things in an NED on a big public board. First, some kind of domain experience that is seriously relevant to the business and the needs of the board. A deep domain knowledge that the person holds. For example, as chair of an insurance company, it's really useful to have a few directors who have actually worked in the challenges of the insurance industry. And you need deep domain experience is a role such as the chair of your audit committee.

Second, you must have the ability to work with a small group. You have to have the personality, the breadth of knowledge, the willingness to be part of a team, and you have to have the EQ to sense what your role is in that group. The role of the chairman is very different from the role the NED, and the role of the brand new NED is different from someone who's been on the board for six years. You need the social skills to interact in a team environment of seven or eight people.

CC: I'll add that if you're considering a NED career, some people have deep domain skills and want to stay in that area, while others span across broader areas such as corporate governance. In my experience, I've tended to stay in the area of investment, superannuation and finance generally. I did step outside my expertise once but I found that I didn't really enjoy it because I was not adding the value I wanted to. I needed to know better what was fact or fiction.

VO: What key role does diversity play on a board? Elizabeth?

EB: You need to set up a collegiate atmosphere around a board table, where people respect and listen to each other but come at things from slightly different angles. That is diversity.

The second step some people take is that for diversity of thought, there needs to be diversity of background and diversity of experience. At some point, you have to realise that the board members must be able to talk amongst themselves. When boards are structured with one person from every state, and three of this and four of that, and someone representing something else, you never find a common ground.

VO: Have you had experience with poorly-functioning boards, perhaps where the line between management and board was unclear?

CC: Yes. When you first move from a CEO to a NED, it takes a bit of restraint. It's the role of a seasoned chairman, early in the piece, to take a new director aside and make clear where that line is. There's nothing worse than board members fiddling in management matters and management don't like it. It's dysfunctional because everyone starts second-guessing. For me, the main role of the board is to support management, not try to catch them out.

EB: Boards can go wrong for many reasons, and directors should take a good look around the table at who they are working with. Are they the solutions or the problems? You have some individuals who want to dominate, or the chairman's worst nightmare, the incessant talkers. There is no polite way to shut them up but you have to find a way to do it.

At the other end of the spectrum are people who never say anything or even worse, don't say it at the meeting but talk about it afterwards. The social construct of a board is difficult, so you need the knowledge, the experience, and then you need a social construct that enables members to act effectively as a group of people. And that's the real seriously tricky part.

CC: I once served on board with Elizabeth when she was chairman and I was a new director, and she said the role of chairman was worth about twice any NED. Later I thought it's at least two times, because you spend so much time on the EQ stuff. A chairman is like the conductor of an orchestra and you need to know how to play all the instruments.

EB: Can I add that boards in Australia are going through a difficult patch, as we've lost the high moral ground. Anyone thinks they can have a cheap shot and there's not that much you can do about it. But here's my personal view. There's been a change. We've had very high growth rates out of profit-maximising capitalism, but what it's done to our income distribution, to our service levels, to the kind of values that exist in some parts of the business community and society, is questionable. And I personally think we're seeing the customer turn. With the companies that I work with and advise, my energy goes into getting ahead of the wave on these issues, thinking how you can find something that blends with your business model but also contributes to a wider group of stakeholders.

If you just go for either platitudes or philanthropy, you don't have something that's sustainable. In my view, the key for all leaders in the business community now is to understand the business deeply enough to know what they can do that makes a wider contribution to their societies, but also works with a business model.

CC: I agree but smaller companies are more about surviving. If you're on the board of a small company, worrying about the community or whistleblower policies or cultural statements can waste a lot of time. You have to pay the wage bill next month. It's horses for courses.

EB: Yes, I was talking about large companies. I add that you must be very careful with buzz words like sustainability, transparency and the one I hate most, agility.

MFS's Carol Geremia on short-termism and time tolerance

30 October 2019

Carol Geremia is President of MFS Investment Management, which manages about US$450 billion with headquarters in Boston, USA. She has worked at MFS for 35 years and has seen many investment cycles play out.

GH: You have written about misalignments in the asset management industry. What is the most important the industry is now facing?

CG: The most obvious one is what active managers say is their main goal - to outperform over a full market cycle – and what the industry has actually anchored around.

The industry focusses around three to five years, more towards three and arguably even one year. We've confirmed this with global studies to check perceptions. But against this, a full market cycle is much closer to seven to 10 years, and now we're in this extended bull market that's going even longer.

GH: It's already over 10 years since the 2009 bottom.

CG: Yes. If you're a long-term active manager, and your purpose, first and foremost, is to put money to work responsibly, to allocate capital responsibly, that is what will create value over time on a long-term asset. But people don't understand the full market cycle of peak to peak or trough to trough. It must include the bull and the bear, it's not just one side. So we've already started off from a place of misalignment.

Active managers have thrown this out the window and said, "Nobody's giving me the time, so let's not even talk about it." That's the most acute misalignment.

GH: And you put the blame on the industry rather than investors?

CG: We try to micromanage the debate but I worry that it translates into a blame game. We haven't had enough aligned conversations on the subject of time. Fund managers are under so much pressure to deliver alpha (*Ed, returns above the index*), that even when everybody's making money, if managers don't generate alpha, it almost feels like they've lost somebody's money. But most haven't even come close.

GH: Yes, with the market up strongly over the last decade, investors have had a good time.

CG: We need some different performance metrics, because outperforming a price momentum biased benchmark all the time is not what investors should pay for.

GH: And focussing only on performance and not on risk.

CG: That's the whole point. At some point, if an investor picks an active manager, they really should watch if they have counter-cyclical skills. Can they go against the grain at the right time? There's a lot of concern now that pro-cyclicality is happening. It's chasing past performance and shorter and shorter periods of time, and that will cost end investors.

GH: And some value managers feel they must chase growth stocks at what is probably the wrong time.

CG: And it becomes this style game, active versus passive and hiring and firing active managers, all at the wrong time. The industry can do better than that.

GH: One of the changes you are making which I like is in the way you set out your performance tables, putting the long-term numbers first. The first column is the 10-year number. In fact, today I saw a presentation where the manager showed their one-month number first.

CG: Putting long term first is not a unique idea, but the beauty of it is not only the measurement itself, it's the opportunity for a dialogue with the client. It leads to a discussion on greater trust, clarity, transparency and understanding. They might ask, "Why are you talking to me about the 10-year number?" And we can say, "Well, even though my one-year number is good, I want us to manage the expectation that the 10-year number is more realistic."

In my career, I came out from the fiduciary world of the 401k business (*Ed, retirement plans in the US*). I ran that for about 20 years at MFS, and we changed our statements to start with the 10-year number in the retirement plans. It helped with client conversations. We realised when we did education sitting with company employees, and said, "Here's a stock, here's a bond, here are your 30 options," it was just confusing for them. So we realised, okay, what can we tell them that really helps? And the most common question was, "How much risk should I take?"

GH: What's the response to that question, whether to a retail investor or institution?

CG: My only answer is, "Tell me how much time you have." We used to call it risk tolerance but it's really time tolerance.

Finishing that point on the statements, we did that in the late 1990s when the market was rocketing up, and we were worried that people were taking too much risk to chase the returns versus realistic long-term expectations.

GH: Within your own company, how do you create the right long-term thinking when people are paid bonuses each year and in all personal lives, everyone has both short-term and long-term needs and goals?

CG: You absolutely must, and it starts with a culture that values a long-term view. And I don't say that lightly and we even say loyalty is important. And when people say, well, in today's world, loyalty might mean complacency, my response is that loyalty at the best firms in the world is probably the number one attribute. It's not complacency. It's the values that having a long-term view is the right thing to do if you're caring for something that's not yours.

So that must be real. You can change remuneration, for example, we don't pay bonuses on one-year numbers. In fact, we pay on the longest track record that somebody has. You must watch the incentive misalignment. You can't expect people to run money with a long view if you drive short-term incentives. And you must run the business that way too, which sometimes means short-term pain. But I do think the culture piece is the hardest. You must believe it.

GH: MFS is an active manager, and in Australia at the moment, including in the media and by the regulators, there's a strong focus on fees rather than net performance or risk. And it's fair to say that the active managers are losing the passive versus active argument in the public domain. How can the active managers fight back?

CG: We have to, but do it in a way that is not self-serving. I'm cautious about conversations that involve self-reflection. Here's the thing. Over what period of time are you measuring active manager performance? That's my first question. The good managers deliver over the long term, and we have the data to show it.

But I actually think the comparison is a good thing. The investment industry is managing US$100 trillion globally. That's a lot of money to oversee and a lot of people to serve. I think that the growth of passive is to the benefit to active management, as it will weed out the mediocrity that is in the system right now.

GH: We're certainly seeing plenty of fund managers leaving the industry.

CG: But the second piece is it will define more clearly why investors pay an active manager and what they are paying for. People pay for quality, but what is quality in the investment business? I know when I buy a quality jacket, I can tell it's been well made. What is it in investing? I say it's responsibility, putting money to work responsibly in this system?

By the way, the public markets are under massive threat. If we don't take care of public markets, the whole system, we've got much bigger problems than passive versus active. We as an industry in active management, if we say we're long term, we must prove it. Conviction is not only position, size or concentration. Conviction should be capital commitment to great underlying businesses that will create value for shareholders, and the whole system, communities, employees. The debate is more about shareholder versus stakeholder and the efficiency of capital allocation.

There's a lot of capacity chasing risk right now and active and passive can work together. Investors pay active management a premium to hold corporations accountable with true engagement, way beyond proxy voting.

GH: What types of engagement, other than proxy voting?

CG: There's tons of it. You embrace understanding the business and its competitive dynamics. You talk to management about what you think they do well or don't do well. You ask them about their long-term strategy. Proxy voting is important but it's only one piece of the pie.

GH: You've had various roles in MFS over 34 years. Can you identify one good change about the asset management industry, and one unwelcome change?

CG: The best thing that has happened is the democratisation of investing. As much as we beat each other up, the amount of long-term savings and wealth that has been created is considerable. Now, I'm very sensitive that the distribution of that wealth is quite warped, but investors who did not even know what a stock was in the past now have easy access to invest.

GH: That's the plus, what's the minus?

CG: The exact flip side of that is the amount of communication, education, responsibility and obligation we need to get this right. To fight against the misalignments that have crept into the system. About 80% of public markets is now owned by institutions, the mutual funds, superannuation funds, pension plans. But 25 years ago, that was 30%. We have this long chain of intermediation which creates agency issues amongst ourselves.

But we're trying to micromanage each other and hold each other accountable so much that we can forget about what it means to the end investor. We have to improve communication because investors are now taking five times the amount of risk to get the same return than they did 15 years ago. We must talk to them about extending the investment horizon and it's not because we want to get paid longer. We are taking risks with their money and they must understand.

GH: Here's my one macro question. Do you think the massive expansion of central bank balance sheets and injection of trillions of dollars of liquidity will end badly at some stage?

CG: Well, I like to be an optimist, but the market is very distorted. I understand the importance of keeping the economy growing, but at some point, we must come up with a better strategy. I think we can because it's amazing the things that we can do.

GH: If you think about all the trends in the world, such as demographics, climate change, the aging population, technology. Do you think the market is missing a global trend?

CG: There are so many huge disruptions that are impacting everything, ranging from absolutely terrifying to cool and exciting. Technology, innovation, it's endless, we could go on and on. Yet we are missing the biggest thing in our industry, and that's alignment. We need better ways to manage risk and extend our time frames.

MFS has undertaken a two-year exercise internally, instigated by the MFS Board, to identify its own misalignments, including internal and with investors. The Board wanted to see options that ensure fund performance is consistent with how MFS views performance. The case study is attached here.

Peter Meany on global trends in infrastructure assets

20 November 2019

Peter Meany is Head of Global Listed Infrastructure at First Sentier Investors (formerly Colonial First State Global Asset Management). Peter established the strategy in 2007.

GH: Infrastructure has many attractive features such as high barriers to entry, predictable cash flows and pricing power. What is the most powerful business attribute for your investing?

PM: They're all important and they interrelate. High barriers to entry often bring predictable cash flows. If I had to pick one, it would be pricing power. An ability to charge prices at or above inflation separates the good companies from the great companies. Combined with an essential service, something that people need or want, the ability to price that is incredibly attractive.

If we are heading into lower growth in the long term because of demographics, or over the medium term because of economic conditions, that pricing power becomes even more valuable.

GH: Yes, I always think of Sydney's Eastern Distributor opening with a toll of $3.50, and now it's $7.76. And with automatic tolling and tags, drivers don't even hand over the cash so they feel the cost less.

PM: It's a classic example. The price started at a reasonable level but we've had increases over time at the higher of 4% or inflation. WestConnex will have the same pricing structure for 15 years so it's a valuable franchise.

GH: What global trends are the most powerful for supporting infrastructure at the moment?

PM: There are a few. The longer-term structural drivers such as decarbonisation of the electricity grid are important. The world is moving to renewables and less carbon intensity and the infrastructure needed is significant. On the one hand, it has negative implications for old fossil fuel power stations and the like but there's a whole new need for investment in wind farms, solar panels and increasingly, battery power storage. We'll have new transmission lines, distribution networks, smart meters.

Elsewhere, the move towards electric vehicles means charging stations will need significant investments. A well-positioned utility company can more than offset the negatives.

GH: Will the market address these trends or should the government be doing more to encourage the changes, particularly in Australia?

PM: We need both. Governments can create certainty of policy and I think that's probably been lacking in Australia, such as what the country wants to achieve with a renewable energy target. Some incentives and penalties might help, then businesses can work with that if given enough time to adjust their capital expenditure and business models accordingly.

In the US, Federal politics has probably played less of a role. Their shift to renewable energy has been more due to state-based targets, such as in Florida, California and Texas.

But economics always beats politics. The reality is, with the investment that's taking place in renewables, we've moved a long way down the cost curve towards cheaper cost than fossil fuels.

GH: Which renewables are cheaper now and which have yet to catch fossil fuels?

PM: Onshore wind in the US is already there. Solar is probably a few years away, and it needs battery storage to extend the utilisation. Renewables are cost competitive with gas-fired power plants, and they've already surpassed coal and nuclear.

My favourite company example is NextEra, the world's largest renewable company and a big part of our portfolio. They've got some projects now where they combine wind and solar at the same facility with battery storage, and that increases the hours of the day that the facility is utilised.

GH: In Australia, most of our power still comes from coal, and yet we have an investor and public movement against coal. How do you see the timing of that transition, especially since your business is positioned as a responsible investor? Isn't it a difficult call to decide we're ready to move on from coal?

PM: Being a responsible investor also requires thinking about the sustainability of an energy market. While it would be good to go 100% renewable in a year, the practical reality is that we cannot achieve that, given the scale of the problem. It would help if we had some clear policies on when we want to achieve it.

The economics are moving so quickly that we will probably bring forward some of those longer-term decarbonisation dates. It's a 10- to 15-year story rather than 25 to 30 years. I'm in the school that accepts for the next 10 or 15 years, a balanced generation mix make sense. We should be working with our companies to drive earlier changes and accept that gas will act as a transition fuel, while the future will be a lot more renewables.

GH: For the last 10 years or so, falling interest rates have provided a tailwind for your investments. While it doesn't look like rates will rise soon, at some point, we will have another cycle. What are the most resilient parts of an infrastructure portfolio against rate rises?

PM: Firstly, it depends how sharply rates rise, because businesses can adjust better to a gradual increase. If rates rise because of improvements in real economic growth, then there will be more traffic on roads and passengers through airports.

If rate rises are driven more by a pickup in inflation, most infrastructure companies that we invest in have the ability to pass on increases. It might not be as direct as a Transurban where it is quarterly, but it's at least annually in most parts of the world. So in the medium term, whether rates are going up or down, doesn't really concern me.

It's the short-term, sharp movements in rates of 100 or 150 points (1% to 1.5%) in a three or six month time frame that you see big sector rotations as people shift from defensives to growth sectors, and there's not a lot we can do in that short period of time.

GH: What types of infrastructure assets do you think will do best in the next five years?

PM: It depends somewhat on the economic and bond yield environment. If we're in a steady state, we prefer companies with good organic growth, prices linked to inflation and room for additional investment to expand a network. Toll roads are a good example. We also think mobile towers will continue to do well. There is massive demand for mobility of data, such as downloading Netflix on the phone and video games in high definition as we move from 4G to 5G. We are simply going to need more towers, small cells and infrastructure to support that demand.

GH: Is there a listed player in Australia in that space?

PM: Unfortunately not. Many of the towers here are owned by Telstra. The Vodafone Optus towers were sold by a US company, Crown Castle, to an unlisted Macquarie consortium.

This portfolio diversification is an advantage of being a global investor. While I love the thematic of mobile towers, I can't play it on the ASX, while there are three big tower companies in the US that apply the theme exceptionally well (American Tower, Crown Castle and SBA). We also owned some European companies and just last year, the big Chinese telecom operators separated out their towers into one vehicle.

GH: Do you see any threats or worries to a particular sector, such as global epidemics for airports and ports?

PM: We saw September 11 and SARS affect airports, which was dramatic but in fact, short lived. Infrastructure is usually an essential service driven by long-term structural factors. We've seen earthquakes, terrorism, epidemics, bridges collapse. They make the news but in a diversified portfolio, they tend to come and go quickly.

Longer-term disruption events are more significant. Think about the potential impact of 3D printing on the world's chain of infrastructure. There's the manufacturing of a $5 toy in a western province of China, and all the roads and ports on both sides of the world until it reaches New York. There's a massive amount of infrastructure moving low-value goods around the world. If 3D printing develops over the next 10 to 15 years, it might lead to more deglobalisation.

GH: Do you have a view on whether autonomous vehicles will be a plus or minus for a toll road business like Transurban?

PM: I'm definitely in the plus camp. Over the next 10 to 15 years, autonomous vehicles will create more trips. There might be less cars registered, but there will be more ridesharing and third parties owning vehicles.

GH: They become more part of the 'public transport' system.

PM: Yes, and what about a future business model where the car manufacturers own the vehicles? You have a contract with say BMW, and a car that you select turns up at the door and takes you anywhere. Business models will evolve making it easy to do more trips. At the moment, people drive their car into work, pay a $4 toll and then $50 to park. Why pay for car parking when an autonomous vehicle could be sent back home? Or it could be used as an Uber during the day.

In the long term, when the whole fleet of vehicles is autonomous, perhaps the road network works more efficiently with less congestion.

GH: Your fund is up 13.5% per annum over seven years, and I'm sure you would bank that result again if you could. What is more realistic for the next five years?

PM: We've always said 8 to 10% total return through the cycle. The seven-year number is picking up from some low points and I would stick to 8 to 10% over the long term: say 3 to 4% yield, plus 5 to 6% growth. Over the next five years, perhaps we could see a 5% return if there's a bit of mean reversion on growth and yield.

GH: Your fund is listed assets only. What do you see as the different opportunities between listed and unlisted?

PM: Both are buying the same underlying infrastructure assets generating the same cash flows. They're just held in different vehicles, which have pros and cons. Unlisted infrastructure has the advantage that revaluations are done infrequently, say every 6 to 12 months, which make them appear to be less volatile.

GH: And that has value from a reporting viewpoint.

PM: Yes. And there's an argument that a controlling investor has more influence over the investment. In the listed space, we offer liquidity and the ability to strategically and tactically reset our portfolio. When we see trends evolving, we can move in and out of sectors and countries and evolve the portfolio. We give investors instant diversification which would take a decade to build in a new fund in the unlisted market.

Talking my book, I believe listed infrastructure companies have become higher quality because they work to achieve a rerating as investors like us give them feedback. We might suggest that if they sell some non-core assets or reduce their commodity exposure or economic risk through contracts, they can have a better, lower risk business. Then the market will reward them.

In the unlisted market, there is so much capital chasing so few assets, many infrastructure managers are broadening their definitions, from 'core' to 'core-plus', into areas such as car parking and merchant power generation, and shifts into less-developed countries which do not have strong political and legal systems. They are going up the risk curve.

GH: Do you have a favourite Australian and a favourite global stock at the moment?

PM: In Australia, I can't go past Transurban. It's the only Australian stock we own at the moment. The value of its networks is unique. Governments around the world need to think about congestion pricing in large cities, and Transurban owns and controls the network to do that.

Globally, we like NextEra, with half the business as a regulated utility in the high growth state of Florida, and the other half a renewable energy developer and owner. Over the next 10 to 15 years, it will be the scale operators that are best positioned, the ones that have moved further down the cost curve.

GH: Final question: has your business recognised a trend that the market is underappreciating?

PM: What we do well by being global is recognising trends that are happening in one part of the world, and seeing that as an opportunity in another part. Examples include in the satellite and mobile data space. Back in 2015, there was a clear trend in UK and Europe away from the set top box. It meant getting out of the satellite sector and moving the portfolio heavily into mobile towers.

But it's also learning from mistakes. Germany 10 years ago moved into renewables early, and that had a significant negative impact on coal-fired generation in that country. Having made a mistake there, we moved our portfolio in the US away from utilities that had exposure to coal and more towards renewables.

Infrastructure seems like one sector but we think of it as many sectors, with specialisations within. Take mobile towers out of telecom, take airports and toll roads out of industrials, and then we see the interesting parts of each. Autonomy, 5G, 3D, globalisation, Brexit ... there are so many interesting things for an active manager.

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