Cuffelinks
Connecting investors with ideas

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Infrastructure risk factors in the current macro environment

Gerald Stack

Over the past six months, we have seen an environment of lower growth in China, uncertainty in equity markets, continuing downward pressure on the prices of resources, the start of a Federal Reserve ('Fed') tightening cycle and signs of a potential high yield credit squeeze and repricing. These are all cause for us to reflect on our approach to risk.

At Magellan, we seek to take a holistic view of infrastructure which considers various risk factors in whether an asset meets our definition of infra-structure and standards for investing. The stability of earnings is determined by more than an asset's competitive position; there is a range of other risk factors which will influence earnings streams.

We assess many risk factors, but the past few months have highlighted a few worth considering:

- **Sovereign risk:** we avoid countries where political decisions can easily be made which undermine the contractual position or potential earnings of a company.
- Additionally, we only invest in countries where the judicial system and law are sound so that contractual positions can be enforced in need.
- **Regulatory risk:** we avoid jurisdictions where regulatory processes are opaque or inconsistently applied.
- **Commodity price risk:** we do not invest in businesses which are materially reliant on the price of the product which they transport e.g. many pipeline businesses and Master Limited Partnerships (MLPs) in the United States are excluded from our universe for this reason.
- **Leverage risk:** we avoid businesses with high leverage or where their ability to service their debt is tight relative to their earnings.

Interest rates, debt and leverage

We expect global monetary conditions to experience further tightening over the medium term and, consequently, for longer tenor rates to increase.

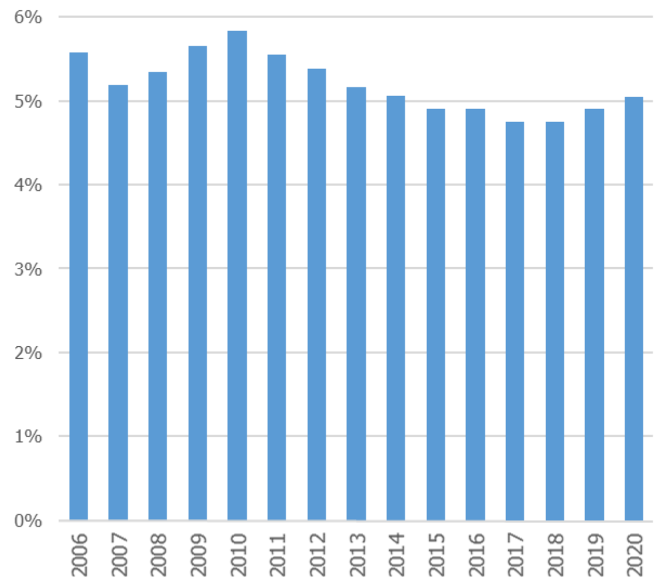
There are two key areas to focus on when considering interest rates: the impact on the businesses in which we invest, and the impact on valuations and on debt and equity markets.

1. Impact on the businesses in which we invest

We are confident that the underlying businesses in which we invest are in good shape, have strong capital management and are well-placed to manage successfully any inevitable increases in base lending rates. Strong capital management is critical and means these businesses largely have:

- Solid investment grade credit ratings, which are important to ensure they have access to multiple credit markets at all times regardless of credit cycles.
- Strong credit metrics i.e. they have a level of leverage that underlying earnings can comfortably support, and have strong debt service ratios. We estimate that, on average, the companies in our investment portfolio generate free cash to service debt of more than four times their annual debt service, which we view as a strong buffer particularly given the stability of the underlying earnings.
- Access to various debt markets (e.g. US, Europe, Canada, Australia), meaning they are not reliant on any single market.
- Improved credit ratings over time as their earnings and credit metrics have improved.
- Available liquidity and credit facilities to fund expansion or liquidity requirements.
- Lengthened and de-risked their debt maturity profiles so that the average repayment term dates are typically 8 to 10 years out, and repayments of debt in any single year is not excessive relative to the total debt burden.
- Managed interest rate exposure by undertaking material interest rate hedging or issuing fixed rate bonds to ensure earnings remain stable over the longer term.
- Reduced the cost of their borrowings throughout 2010 to 2015 by taking advantage of cheaper credit (lower base rates and margins), but also have further opportunity to reduce debt costs over the medium term by replacing more expensive 'old' debt which is becoming due for repayment over the next few years.

It is important to note this last point. While interest rates are very likely to increase in the United States in the next few years, the average cost of debt of the US stocks in our funds is likely to continue to fall as maturing debt is replaced with cheaper debt. As an illustration, the following graph shows consensus forecasts for the average cost of debt for Kansas-based power utility, Westar Energy Inc, showing the average cost of debt declining until 2018.



Source: Magellan Asset Management Limited

So overall, we remain confident that these businesses are well-placed to continue to meet our investment expectations over the medium term and through a period of rising rates.

2. Impact on valuations and on equity markets

An increase in interest rates can be expected to lead to a higher cost of debt and an increase in long term discount rates. Our forecasts and valuations take these factors into account in our investment analysis. However, the history of financial markets leads us to expect increasing uncertainty as a consequence of a rising rate environment.

Stocks which are regarded as 'defensive', including infrastructure and utilities, are often subject to negative sentiment during periods of interest rate increases as investors switch to higher growth sectors. However, it is our experience that, provided the businesses have solid fundamentals, their stock prices can be expected to revert to trend reflecting their underlying earnings profiles.

Notwithstanding equity market volatility we expect that underlying earnings of infrastructure and utilities companies in our defined investable universe should continue to be robust and reflect solid growth.

Ultimately the value of the companies in our investment portfolio reflects the future cash flows they are expected to generate and the risks associated with those cash flows. Magellan believes that, at the current time, investment markets are not pricing assets at the prevailing interest rate levels but rather, are pricing in a higher, more 'normal' level of interest rates in assessing the risks associated with future cash flows. This means that if interest rates increase over the medium term we can expect the impact on asset prices to be somewhat muted because investors have already allowed for some level of increase.

Gerald Stack is Chairman of the Investment Committee and Head of Investments at Magellan Financial Group and Portfolio Manager of the Magellan Infrastructure Fund. He has extensive experience in the management of listed and unlisted debt, equity and hybrid assets on a global basis.

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The 'January effect' in stock markets – Part 1

Ashley Owen, CFA

The idea that share prices have historically done better in January than in other months is referred to as the 'January effect'. Since January 2016 was such a bad month for shares in Australia and around the world, I have had more questions than usual from investors about this phenomenon.

In Part 1 we look at whether there is in fact a 'January effect' in the US (where the theory originated) and in Australia.

Then in Part 2 we will look at what January's returns can tell us about the likely returns for the rest of the year.

The 'January effect' in the stock market

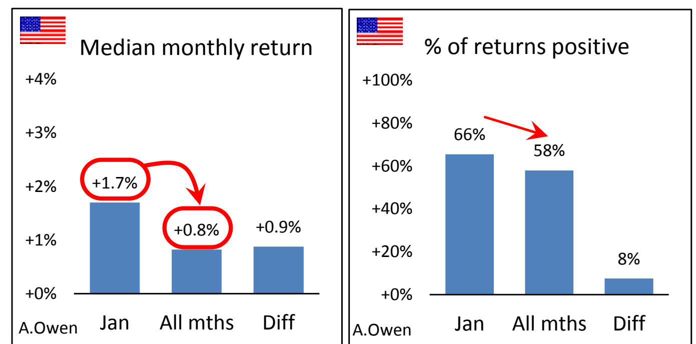
In the US stock market, January has delivered above-average returns from shares relative to other months of the year. This phenomenon has been observed at least as far back as the 1920s. I recall first reading about it in the 1980s, and it is still referred to as a market 'anomaly' or 'inefficiency'.

Various logical explanations have been put forward. Most relate to the timing of tax payments and end-of-year bonuses which are invested in shares in January. Other explanations include optimism from the festive season and year-end reflections and commitments to start or accelerate investment plans in the New Year.

This market inefficiency sounds like a way to make easy money. If it were true, we could simply over-weight shares in January and then go under-weight for the rest of the year, generating higher returns than by than simply remaining passive and sticking to the same allocation for the whole year.

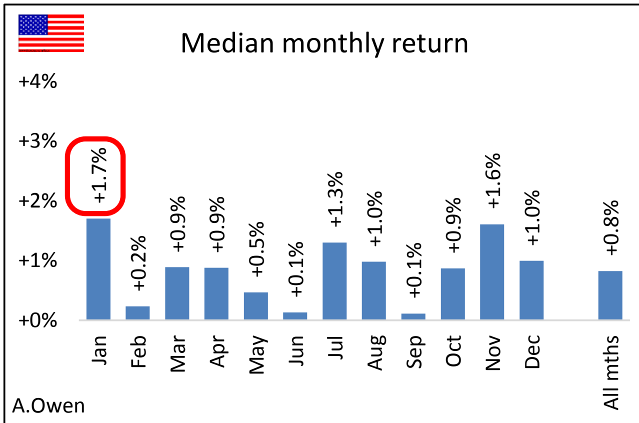
Surely the market would not allow such an obvious inefficiency to last for long?

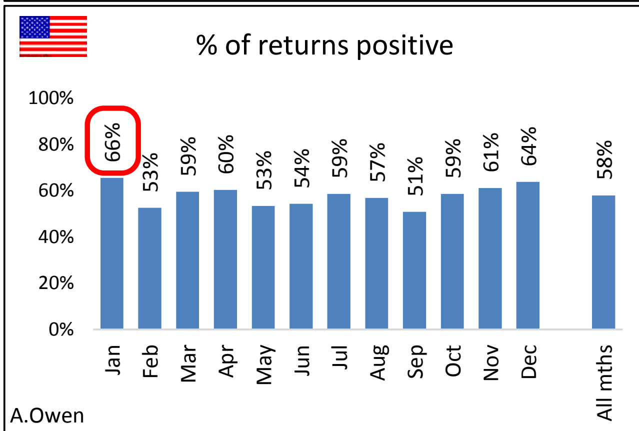
The first pair of charts show price returns from US shares in January compared to the average of all months, using the S&P Composite/S&P500 price index returns from US shares from 1900 to the end of 2015.



The left chart shows the median January return was 1.7%, which has been double the median return from all months. This difference is statistically significant, not a random aberration. The right chart above shows that monthly returns have been positive in 58% of all months, but positive in 66% of Januaries, so the incidence of losses in January has been lower than in other months.

Indeed, averaged over the whole period since 1900, January has been the best month for US shares. January has had the highest median monthly price return of all months (top chart below) and the highest incidence of positive results, meaning the lowest incidence of negative months (bottom chart below).



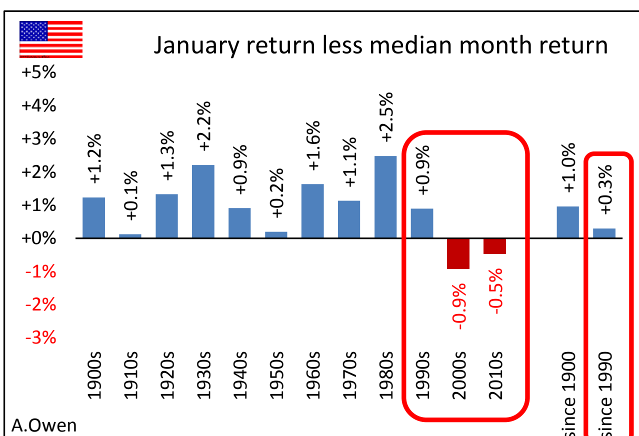


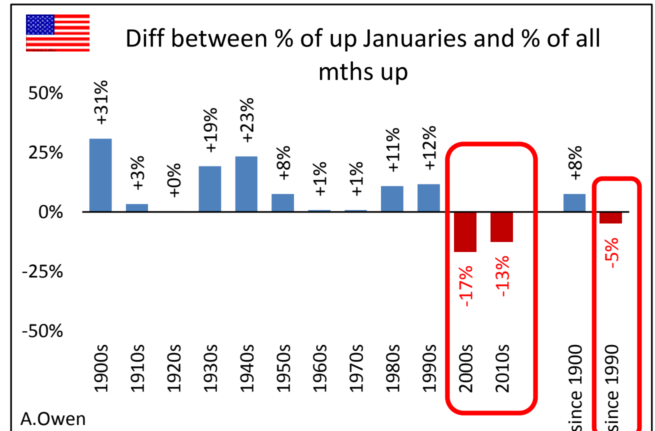
So far so good. We could buy or go overweight the market (for example, via a broad market ETF) at the end of December or the start of January and then sell or underweight at the end of January, wait eleven months and do it again next year, and so on.

What's the problem?

The problem is that the 'January effect' has been so extensively written about that it has been 'arbitraged away' (exploited so much that the advantage no longer exists) since the 1990s.

The following charts show the January effect by decade:





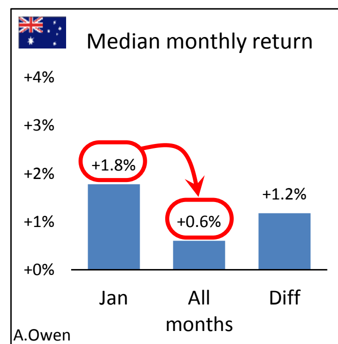
The first shows the excess of January returns over returns for all months. A blue bar means January returns were higher than the overall monthly average return, and a red bar means January returns were lower than the monthly average. The second chart shows the excess of January incidence of positive months relative to all months. A positive blue bar means Januaries had higher incidence of positive returns than other months.

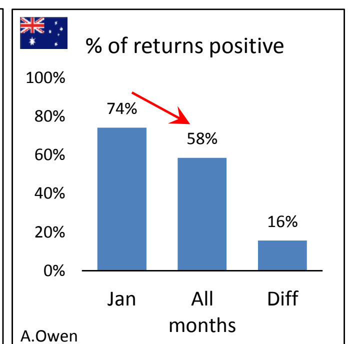
The January outperformance varied over time but it was consistently positive until it disappeared since the 1990s.

Why? The 'January effect' was exploited by a few large investors who had enough scale, access to markets and instruments to overcome the high costs involved in exploiting the anomaly. Since the 1980s, the advent of cheap computing, lower brokerage, accessible futures markets, the rapid proliferation of hedge funds and low cost ETFs has meant that everybody could now try to exploit this 'free lunch'. Further, the charts show that it may have even reversed in the 2000s and 2010s.

Is there a 'January effect' in the Australian stock market?

Just like in the US, there has also been a January effect in Australia over more than a century since 1900.





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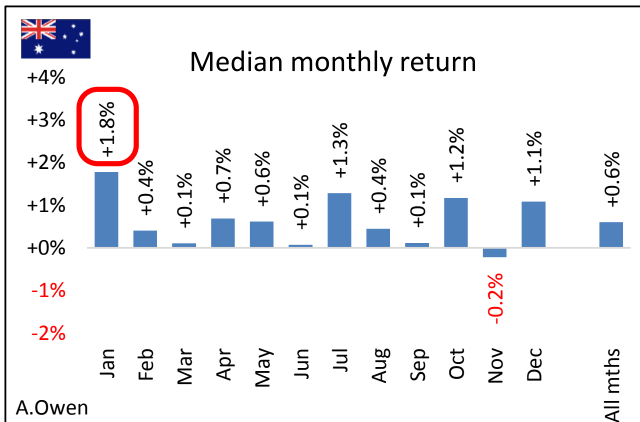
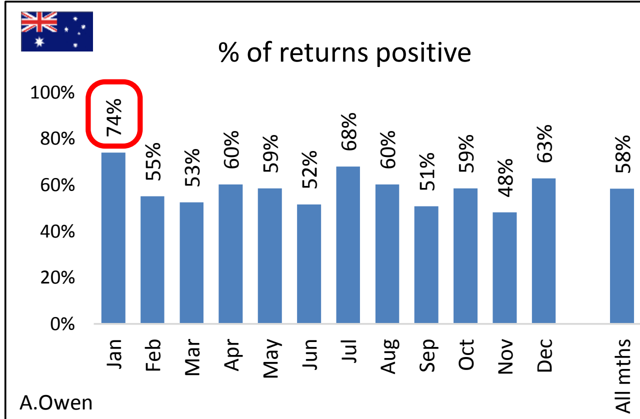
The left chart shows the median January return was 1.8% (similar to the US). In Australia the median January return has been three times the overall return over all months, even more than in the US. The right chart above shows that monthly returns have been positive in 58% of all months (similar to the US), but positive in 74% of Januaries (even higher than 66% of Januaries in the US).

Averaged over the whole period, January has also been the best month for the Australian stock market, as it has been in the US:

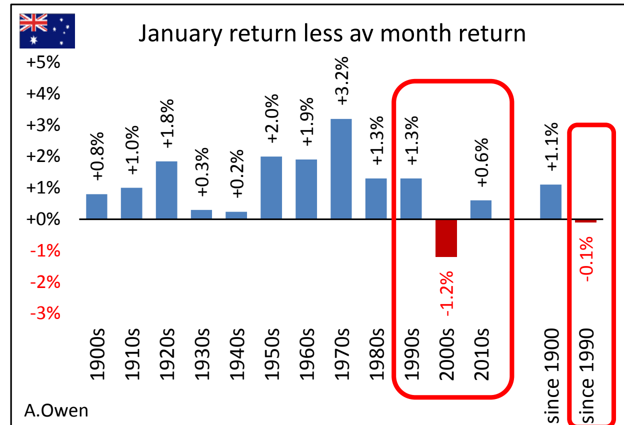


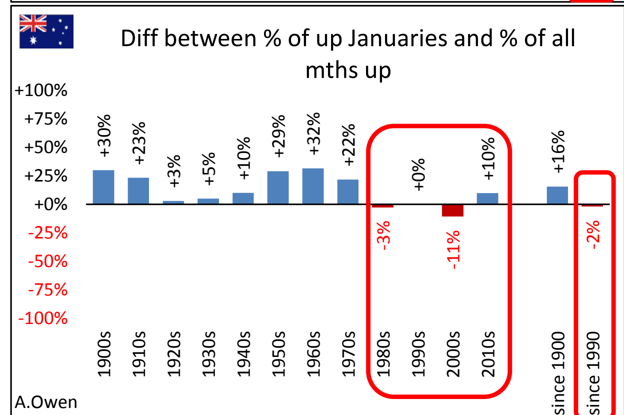


So the January effect has been even more pronounced in Australia than in the US market.

Although the timing of tax payments in Australia is different from the US, and year-end bonuses are not as extensive here, the January effect has still been present in Australia. One reason may be that the Australian market has always been heavily influenced by foreign money flows and our local market has been a natural beneficiary of the US effect. Another reason may be to do with investors re-balancing and setting up new portfolios after December year-end reviews.

However, just like in the US, the 'January effect' has not been present in Australia since the 1990s.





There's no such thing as a free January

Stock markets, like all markets, contain market inefficiencies - 'free lunches' – from time to time. Some last for short periods before being discovered, exploited and arbitraged away. Others can persist for long periods before being lost due to the use of new technologies, instruments or changes in market structure. Hedge funds often find a market inefficiency, exploit it quickly before the rest of the market joins the party and closes the gap, and then go in search of the next inefficiency.

The 'January effect' persisted for more than a century but alas it has disappeared.

(In Part 2, we will look at what January's returns can tell us about the likely returns for the rest of the year).

Ashley Owen (BA, LLB, LLM, Grad. Dip. App. Fin, CFA) has been an active investor since the mid-1980s, a senior executive of major global banking & finance groups, and currently advises high net worth investors and advisory groups in Australia and Asia. *This article is general information and does not consider the personal circumstances of any individual.*

Key investment take-outs from Paris Climate Conference

Pablo Berrutti

Between 30 November and 11 December 2015, 45,000 delegates, including heads of state, from over 100 countries, met in Paris for the Conference of the Parties (COP) to the UN Framework Convention on Climate Change.

The Paris agreement is an historic deal that will lead to significant cuts in greenhouse gas emissions across the global economy through a universal system of governance for climate change. While individual country commitments have still fallen short of the stated temperature target, they are sufficient to accelerate the shift to a low carbon economy which technology is driving forward regardless.

What did countries agree to?

The highlights of the agreement include:

- A change in target from 2ºC to 'well below' 2ºC with an aim of 1.5ºC which was arguably the most significant outcome. While it may seem academic, the importance of acknowledging that 2ºC was not a 'safe' target further emphasises the urgency for action
- A five-year review mechanism with a clear expectation of more ambitious targets. This ratcheting approach should factor into investment analysis as it increases the likelihood of accelerating change
- A commitment from developed nations to grow their financial assistance for developing nations to manage climate change to more than US$100 billion a year from 2020. Much of this finance will have an explicit goal of attracting additional private investment.

Other noteworthy outcomes from the COP were outside the negotiating rooms with hundreds of companies, sub-national governments and investors making significant commitments. For the first time, the scale of private sector support reflected what is needed to achieve more ambitious climate action.

Implications for investors

The fact that greenhouse gas emissions have continued to grow despite clear evidence of the damage caused is a classic market failure. The Paris agreement establishes a predictable framework for correcting this. Indeed, at no time over the last 21 years of climate negotiations have investors had greater confidence in the necessary changes 'really' happening this time.

While this will be positive for low carbon investments as it signals a reduction in regulatory and market risk, the largest investment implications sit with the primary part of most investors' portfolios - bonds and listed equities.

As the market failure is corrected, the playing field will be tilted from high to low carbon, which will impact all sectors in different ways. The nature of correcting market failures means passive portfolios are particularly vulnerable as changes in index constituents may lag.

Government regulation and international agreements are not the only factors driving this transition, and technology remains critical. Battery and solar price declines are expected to continue, further disrupting energy markets. However, the cheapest form of carbon abatement is the energy not used, making energy efficient will be an important company differentiator.

The combination of international political momentum, private sector support and technological change stand to disrupt many industry sectors faster than expected. The risk of 'stranded assets' has been flagged by everyone from the Governor of the Bank of England to leading sell-side analysts.

Expectations of investors will continue to grow

Scrutiny of investors from asset owners, retail investors and the public has increased over the last few years and this scrutiny will grow post-Paris. The industry itself is lifting standards, with investors representing $10 trillion in assets committing to portfolio carbon disclosure through the Montreal Pledge.

While these commitments are positive, investors need to understand the limitations of these tools. For example, carbon footprinting does not identify stranded asset risk or risks to industries like auto-manufacturing where the greatest threats are upstream or downstream. A suite of quantitative and qualitative indicators will be required to properly understand the opportunities.

What can investors do?

Leading investors are already taking actions which are low cost and process-orientated. Establishing a holistic framework which captures investment process improvements, member engagement, industry collaboration and policy advocacy will aid in

the identification and prioritisation of actions for individual investors.

Actions include:

- Integrating and documenting carbon risk and climate change adaptation into investment processes and governance using tools like carbon footprinting and the assessment of stranded asset risks
- Formalising individual and collaborative engagement programmes with investee companies to benchmark the management of climate change and other key Environmental, Social and Governance (ESG) factors
- Collaborating with other investors to improve industry knowledge and skills and to influence the policy response by government
- Engaging with end investors to reassure them that their assets are well-positioned for the great shifts climate change will mean for the economy and society.

Research we have undertaken shows that investors are concerned about these issues. If funds are not providing sufficient information in an understandable form, investors may move to funds that do.

Final thoughts on Paris

The full effects of the Paris agreement will take time to ripple through the economy. Investors are already seeing the related structural changes that are unfolding due to existing policies and technological development.

However, preventing dangerous levels of global warming remains an unprecedented challenge. While individual country commitments fall short of what is required, the improvements in global governance of climate change achieved in Paris should provide investors with greater confidence that future action will more closely resemble what is necessary.

Arguably, the biggest challenges for investors will be blocking out short-term noise and instead focusing on applying the strategies needed to achieve long-term investment objectives in what are sure to be extraordinary times ahead.

Pablo Berrutti is Head of Responsible Investment, Asia Pacific at Colonial First State Global Asset Management.

Oil price fall will lubricate economic growth

Hugh Dive

There has been no shortage of headlines in recent weeks detailing the woes of the large oil companies as the oil price has continued to fall. The price hit a 12-year low as the prospect of lifting sanctions on Iran raised the spectre of an additional 500,000 barrels of Iranian oil daily hitting the global market. Whilst this has placed a significant amount of stress on companies such as Santos and Origin Energy that are completing export LNG projects that require a high oil price to generate commercial returns, the dramatic and sustained fall does have some positive impacts for investors and the economy.

This article looks at the beneficiaries of the sustained decline in hydrocarbon prices. Conceptually, a fall in the price of oil is not deflationary or negative *per se,* but rather a transfer of wealth from oil producing countries and companies (such as OPEC, Norway, Exxon and Oil Search) to energy consumers (OECD, South Korea, China, chemical companies and domestic consumers).

January 2016 **January 2014**

Over the past two years, despite a 20% fall in the AUD, Australian consumers have seen a 60 cent decline in the petrol price at the bowser, though in researching this piece, I was surprised to see a great dispersion in prices for a litre of unleaded in Sydney from $1.49 in Edgecliff to $0.99 per litre in Marrickville.

Australian consumers benefit

An Australian Bureau of Statistics (ABS) survey reveals that households spend an average of $60 each week on fuel for vehicles, and $41 on gas and electricity for their homes. This equates to average energy expenditure representing 5.3% of total gross weekly household income (2.0% for dwelling energy and 3.2% for fuel for vehicles). The sustained fall in energy prices over the past year has resulted in an

additional $1,154 per annum being added to the average household's finances, with a greater benefit being felt by those living on the periphery of the country's major cities. This additional cash improves the balance sheet of the nation's consumers that can either be spent on consumption or on paying down debt.

To put this in perspective, Kevin Rudd's $10.4 billion 'GFC economic security package' from October 2008 delivered a one-off $1,400 to pensioners and $1,000 per child to families and was credited as boosting GDP by 1%. Arguably the benefit received from falling petrol prices over the past two years should have a more sustained impact than a well telegraphed one-off payment.

Increased domestic spending

The largest beneficiaries of the oil stimulus will be the consumer staples and consumer discretionary retailers. Savings on energy are spent on food and liquor, as well as consumer goods such as televisions and apparel. We expect to see stronger sales figures from *Wesfarmers, Harvey Norman* and *JB Hi-Fi*. The falling AUD is likely to boost the proportion of this additional retail spend that is directed to domestic retailers rather than foreign online sales. *Flight Centre* is likely to benefit from both higher consumer spending and falling airline ticket prices (once fuel surcharges are removed).

Higher retail sales will also benefit retail listed property trusts such as *Vicinity* and *Scentre.* Typically, a tenant in a shopping centre will pay a base rent, variable outgoings to recover the costs of running the centre and turnover rent based on a percentage of the retailer's gross sales. This provides an automatic mechanism for rent to rise when there is an uptick in retail sales. We have seen this in retail sales throughout 2015, particularly in footwear, leisure, jewellery and technology sales as reported by the retail listed property trusts. However, a portion of this improvement in retail sales is also due to a falling AUD, which has resulted in less online spend and an increase in domestic inbound tourism.

Large energy consumers

Amongst the companies that consume large amounts of hydrocarbons, *Qantas* is the most obvious beneficiary. Its jet fuel bill declined from $4.5 billion in 2014 to $3.9 billion in 2015, with $3.5 billion expected in 2016. In 2015 this caused a dramatic one-year turnaround in profitability from a loss of -$646 million in 2014 to a profit of $975 million, aided by higher domestic volumes and the slow removal of the fuel surcharges, which had added as much as $570 to an economy class ticket from Sydney to Los Angeles!

Miners such as *Rio Tinto* and *BHP* are significant consumers of hydrocarbons. Moving dirt consumes a large amount of energy in both cracking the rocks and removing overburden through explosives to moving iron ore and coal to the ports on the coasts off Western Australia and Queensland. Rio Tinto's iron ore division alone spent over $500 million on fuel in 2014 and falling energy prices and a weaker currency will help offset the fall in mineral prices. *BHP* by virtue of its US onshore oil and gas acquisitions is a net energy producer and has written down these assets thrice since 2012.

The petrochemical companies should see a benefit from falling energy prices. *Orica* and *Incitec Pivot* are major consumers of natural gas and ammonia, which they use to manufacture explosives and fertilisers in Australia and globally. Incitec Pivot is seeking to capitalise on US shale gas by constructing a US$850 million ammonia plant in Louisiana.

Oil importing nations

Whilst falling energy prices have been causing much angst in the oil-exporting nations, these declines should provide a boost to the major oil importing economies of China, Europe and Japan. Improving sentiment in the US and Asia will have a bigger impact on the prospects for global growth and Australian exports than oil-induced recessions in Russia, Saudi Arabia, Venezuela or Iran.

The nation that is likely to see the biggest benefit from falling oil prices is China, which in 2015 surpassed the USA as the largest net importer of crude oil and other liquids in the world (7.4 million barrels of oil per day). Clearly a factor that stimulates the economy of Australia's largest export partner (24% of Australia's trade in goods and services) will have a positive impact on a number of Australian listed companies from miners, tourism operators to foodstuff exporters.

Focus more on net benefits of falling oil prices

Whilst most of the attention in the media is focussed on companies that have a negative exposure to a falling oil price, these companies comprise only 3% of the ASX200 (or 6% including BHP) and employ a small proportion of the Australian workforce. Unfortunately, there is minimal attention being placed on the positive impacts of the fall and that the sustained impact is akin to an extended stimulus plan with greater and more lasting benefits than the hand-outs of 2008-2009.

Hugh Dive is Senior Portfolio Manager at Aurora Funds Management. This article is general information and does not address the personal circumstances of any individual.

The most important advice of my career

Graham Hand

It's almost impossible to rise into the senior executive ranks of a major company without the ability, or at least the willingness, to speak in front of a large audience. Junior managers should take every chance offered to them to practice with any group, and actively create such opportunities. Confidence in front of a crowd can make or break a career.

How does this reconcile with the oft-stated statistic that fear of public speaking is usually at the top of surveys of greatest fears, even higher than the fear of death? It's claimed that as many as 75% of people have glossophobia, a fear of public speaking.

So for a moment, let's ignore investing and talk about breathing.

This brief note is not comprehensive advice on how to improve at public speaking, but simply to give you one A4 piece of paper that I received about 30 years ago which significantly improved my management of stage fright. I have revisited this document many times over the years and given it to people I have employed or mentored.

The document, 'The 10-Second "Mini-Tranquilizer" Exercise', is linked here.

It is a quick breathing skill from a 'biofeedback' expert, Dale M. Patterson. Print it out and keep it.

I will let the advice speak for itself, except to explain where I found its application useful.

What insight did this simple breathing exercise give me?

Like most people, in the early part of my career, I felt nervous before a presentation to an audience. Even when I gave monthly updates on the structure of the bank's balance sheet and risk to the board, talking about the same subject to the same group for several years, the nerves would usually kick in. It was uncomfortable rather than debilitating, inducing pacing the corridor to ease the tension, although if I were not as well prepared as I liked, it was worse. The first few minutes were crucial. Once the presentation was in full swing and the questions came, confidence and momentum increased and the focus on the subject took care of the rest.

Good public speaking involves developing a range of skills, and there's no substitute for quality material, practiced and well-prepared.

But here I want to focus on this simple breathing exercise. I obtained this document at a management training course with an emphasis on public speaking.

Without attempting to cover the subject comprehensively, here's the key insight: normally, we think of the brain controlling the body. For example, the brain tells the arm to lift, and it lifts. But here, the flow is the other way, the body to the brain. It's a small part of what is known as 'biofeedback', which Wikipedia defines as:

"a process that enables an individual to learn how to change physiological activity for the purposes of improving health and performance."

By breathing deeply as described in the exercise, the body sends a signal to the brain that there is no threat and to stay calm. The brain does not switch off, it simply becomes aware that the 'flight or fight' feeling does not need to kick in so strongly. In a way, the body starts to control the brain.

Combined with a range of other techniques, I hope this simple exercise does for you what it did for me. It's important to feel some level of adrenaline rush before a speech because it heightens your awareness and shows you care. Just keep it under control.

Graham Hand is Editor of Cuffelinks and as a disclaimer, admits he knows little about the subject of biofeedback. But he is far more comfortable speaking in public than he used to be.

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