

Greg Paramor's Top 5 Articles from the last 5 years

- **Howard Marks on Risk and How To Handle It Today** *Howard Marks*
- **My 10 biggest investment management lessons** *Chris Cuffe*
- **Business model disruption has barely begun: Parts 1 and 2** *Hamish Douglass*
- **The evolution of Listed Investment Companies** *Chris Stott*
- **Real estate social infrastructure coming of age** *Adrian Harrington*

Plus

- **Morningstar 2017 Gameboard and Peer Group Performances** *Morningstar*

Cuffelinks' mantra is "Connecting investors with ideas" and the newsletter has certainly lived up to it over many years. When Graham asked me to pick five articles, it was like being asked to pick the best wines – no one will agree. Picking the best wine depends on individual palates, the region, the grape variety, the acidity, the alcohol content, to name a few factors. Picking the best articles depends on whether you like equities, bonds, property or a combination, are you new to investing or sophisticated, what's your risk appetite, do you study the markets or are you a day trader.

I like to be challenged, I like innovation and I like looking over the horizon. I also like learning from history. The articles I have picked from the Cuffelinks vault reflect this.

[Howard Marks on risk and how to handle it](#): **Howard Marks** has an amazing insight into the markets with more than \$90 billion under management. He is one person who consistently talks about risk. Whilst this article was a summary of a slide presentation he did in 2014, the message is timeless. As Howard said about risk: "something to be managed and controlled, not avoided".

[My 10 biggest investment management lessons](#): Despite this article being written by **Chris Cuffe** for his own newsletter, I have a huge respect for Chris and what he has achieved in funds management. I have no doubt part of his success is that he lives and breathes these simple but insightful lessons. Many people make investing complicated but when you cut through the hype and euphoria, whether in a bull or bear market, all investors whether new or sophisticated, should never lose sight of the basics.

[Business model disruption has barely begun: Parts 1 and 2](#): We are in a world of enormous change and disruption. **Hamish Douglass'** articles provide an insight into the world of disruption and how companies old and new are adapting.

[The evolution of Listed Investment Companies](#): Whilst LICs have been around since the 1920's, the last few years has seen an explosion in the number of LICs and acceptance as a legitimate investment option by institutions, SMSFs, and mum and dad investors. Written four years ago, **Chris Stott's** article concludes, "I believe that the momentum gained in recent years has scope to continue given the thematic for the sector." Well, he certainly got that right.

[Real estate social infrastructure coming of age](#): At Folkestone, we believe that real estate social infrastructure is a legitimate investment option. **Adrian Harrington's** article back in 2015 (please excuse the self indulgence!) defined what comprises real estate social infrastructure, the drivers, the risks and different investment options. In recent years, both institutional and retail capital has flowed into this sector and childcare, seniors housing, student accommodation, health and medical facilities and government assets are no longer seen as the poor cousins to office, retail and industrial assets.

Greg Paramor, Guest Editor

Greg Paramor is Managing Director of the listed property group, [Folkestone](#) (ASX:FLK). He is a past President of the Property Council of Australia and was awarded an AO in January 2015 for services to the not-for-profit sector and the real estate industry.

Howard Marks on Risk and How To Handle It Today

by Howard Marks on September 15, 2014

Best viewed on the website via this link: <https://cuffelinks.com.au/cuffelinks-howard-marks-risk/>.

My 10 biggest investment management lessons

by Chris Cuffe on October 29, 2015

Editor's introduction. There are valuable lessons to learn from Chris Cuffe's experience with the Third Link Growth Fund. The Fund's managers are selected by Chris in a 'fund of funds' structure, and all fees paid by investors go to charities.

Although the Third Link Growth Fund has been a success, if I'm honest with myself, after seven years and with one of the best track records in the market, you would expect it to be bigger than its \$85 million. I'm proud of the pioneering structure, where the fund managers provide their services for free, enabling us currently to give more than \$100,000 a month to charities. That's obviously a great story, but why has more money not flowed in?

Answering this question highlights some big lessons about investment management.

1. Financial services are sold not bought

In commerce generally, the consumer finds the best products in the market, especially with such an open system as the internet. But financial services is an industry where products are sold not bought. There are a lot of middle men and women doing the selling. People struggle to find the best products in the world of investing.

If a fund does not have active sellers and marketers, it doesn't get much support and that's how it's worked out. Listed Investment Companies (LICs) have broker networks that work their clients intensely in the offer period, while dealer groups have advisers who tell their clients where to invest.

In the pre-FOFA time when this Fund was launched, it paid no commissions, and most advisers were commission-based. We're not really long into the post-FOFA environment, but I don't think advisers scour the earth looking for the best products. They have to do the right thing by their clients, but that does not mean finding the very best. It's more what's on their radar screens.

2. Joe Average doesn't have a clue where to invest

In financial services, with most aspects of investing, Joe Average does not have a clue where to start to find the best products. To DIY in financial services is tough for the average person. I can DIY in my back yard by going to the hardware store, working out how to pave a path or tile a wall, but you can't do that easily in financial services.

3. The environment and structure must be right for the product

Third Link does not have sales support other than me telling the story (and I do this pro bono and have limited time given my other activities) and the occasional press coverage, and it lost some of its initial impetus due to

the impact of the GFC. The environment must be right for the product. My Fund was more suited to a one-off big bang, a press event, a launch with a room full of people, sell it and close it quickly on the back of a heap of publicity. I don't think it suits a slow burn of continuous fund-raising over many years. Whether you like it or not, a slow burn means being on the major platforms, financial planner support and a sales force of business development managers. And stockbrokers don't support managed funds.

Third Link is rated only by the Zenith Group and it's only on one platform (the BT platform) to allow people to have a superannuation version. Platforms create administrative work and everyone helping out with Third Link is doing it pro bono, so I have not sought out other platforms.

4. Blending styles is a waste of effort

In my view, professionals blend managers in multi manager funds in exactly the way that gives a mediocre result. Typically, they will blend value managers, growth managers, large managers, small managers, etc and then wonder why they achieve the index less their fee. The results of these blended funds have never been great.

I am not the slightest bit interested in blending styles and so some people are put off Third Link because there is no formal scientific process. My process is called experience – one of finding competent, proven managers who will swing the bat and have a go. I do watch for concentration risk but I'm mainly interested in the willingness of managers to pick stocks ignoring the index. In fact, I like to see a high tracking error which is the opposite of most professionals.

5. Past performance is the best guide to future success

Every offer document in the country says something like 'Past performance is no guide to future performance' or similar. That is exactly the opposite of how I think. It's the best guide to knowing what a manager is really like over a long period. Past performance is extremely important and a great guide to the future.

Only long-term results are relevant. The managers I use are selected for the long term. I have no interest in their short-term results. If it looks like a manager is struggling (which I would only conclude after rolling 3-year periods), I would only exit after say a poor rolling five-year result.

6. Never buy a bad stock because the price is low

I don't like 'deep value' investing where a manager is willing to buy a poor quality stock because the price is so cheap. I don't like people saying a bad stock priced cheap is low risk. I would hate to see any of the stocks held by my managers fall over.

Managers need to buy quality stocks. Adding that to a good track record and a high tracking error should mean my fund will do well in falling markets (which it does) which is a sign of a good portfolio.

7. Watch the level of funds under management

I do look at total funds under management in a manager and the types of stocks the manager buys. A small cap manager in Australia with more than \$1 billion concerns me. And I am cautious about investing with a larger cap manager in Australia with more than say \$6 billion under management. At that level, I need more convincing. Size can get in the way of performance. It's no coincidence that most of my managers have performance fees, which enable them to remain smaller while making it economically viable to run their business.

Most managers talk about staying below capacity and refusing to take in more money but my experience is most don't do that, especially when there's an institutional owner. It's compelling to take more money. Boutiques are best at watching capacity as they can make a lot of money from performance fees if they are good.

8. Don't be afraid of performance fees

I believe managers deserve their high fees based on their performance. In my own personal investment portfolio, I don't care about paying a 20% performance fee (as long as the right hurdle exists) if I'm getting 80%.

It's a great part of the Third Link structure that the managers kindly refund all the performance fees, as well as the management fees. It's the sizzle in the Fund. For most professionals who provide a fund-of-fund product, the underlying fee of each manager is so crucial for their own economics that they cannot pay performance fees. But I'm agnostic to fees so I just look for the best managers.

I have not selected any of the managers based on their willingness to forgo their fees. I select on merit then ask if they will waive their fees. I will restrict the Fund's size to about \$150 million so no one manager has more than about \$20 million.

9. Active versus passive depends on the asset class

The active versus passive debate is not a one-size-fits-all. It should be considered in the context of the asset class. In Australian equities, I'd never invest in a passive fund. You have to look at the index before you go passive. Why would you buy an index which is 30% in banks (mainly four stocks) and 15% in resources (mainly two companies)? Talk about a risky portfolio! It amazes me people would start with that. But internationally, say the MSCI World Index, index investing has merit. In Aussie small caps, you could invest in an index fund but I think there is no upside in having small resources because of their boom and bust track record. And I think the active managers of small cap industrials generally do better than the industrials index because they can find small under-researched stocks. But there's nothing wrong with indexing in parts of the fixed interest asset class.

I hope some of the roboadvice models use active management, especially in Australian equities, but I suspect they are unlikely to do so due to the cost.

10. Business risk guides a lot of investing

It's astounding in Australia the number of managers who won't risk being too different from the index. If they underperform for a short period due to departure from the index, they worry they will lose funds (and maybe their job will go as well). If resources and banks are not doing well, a fund with managers that are index unaware should do well. The best three months of relative performance of Third Link in its history was the last three months as both these sectors fell.

I listened to an active Australian equity manager tell me how proud he was of being index-unaware, yet his exposure to financials was 27%, not the 30% per the index. This is not an active position at all and he is surely being driven by the index. I would think that a position of half or double or nil is more like an active view.

This benchmark risk (that is, the lack of willingness to be different from a benchmark) has a lot to answer for in encouraging mediocre investing across the world. The dominance of these behaviours is far greater than anyone will admit. It drives many professionals to bizarre investing.

I don't have any business risk or career risk in selecting my managers. Third Link is not a business and I'm running only one fund.

The best investors I deal with are totally benchmark unaware, even as to what markets they invest into, local or overseas or cash or whatever.

Chris Cuffe is the co-founder of Cuffelinks and has a [wide portfolio of interests across commercial, social and charitable sectors](#). More details on the Third Link Growth Fund, which has consistently outperformed its benchmark, are on www.thirdlink.com.au. How can we have a disclaimer after such firm opinions? Let's just say anyone should seek professional advice on how these lessons apply to them, as the circumstances for each investor are unique.

Business model disruption has barely begun: Parts 1 and 2

by Hamish Douglass on October 15 & 19, 2017

Part 1

There's a lot of business model disruption in the world and many companies will be left behind by the changes. There will be winners and losers in the years ahead, but sometimes business model disruption isn't obvious. There are first-order effects when you have changes to business models, but when new technology develops, it affects other businesses and other industries and it's often not foreseeable.

Watch for second-order effects

If you look at a photograph of the Easter Parade in New York in the year 1900, it is full of horses and carriages. If you fast forward to 1913, the photograph is full of petrol-powered automobiles. Think about what had to happen, such as rolling out petrol stations. Transportation fundamentally changed in 13 years. In 1908, Henry Ford rolled the first Model-T Ford off the production line which enabled an automobile to be mass-produced at an affordable cost.

Many first-order effects are fairly obvious. If you manufactured buggy whips, you effectively went out of business. If you collected manure in the streets, you went out of business. There were 25 million horses in the United States in 1910 and 3 million in 1960.

The second-order effects aren't as knowable. The second-order effects are what the automobile enabled to happen. An entirely new industry could move goods around far more efficiently. People could start the urban sprawl and move further away. We developed regional shopping centres due to the automobile.

Consider a simple change in technology, the automated checkout, such as in Woolworths and Coles in Australia. Walmart started rolling out these automated checkouts in around 2010 at scale and the other major retailers started doing the same. The first-order effects were a loss of jobs of the people working the checkouts, and retailers reduced their costs. And if one major competitor does that, other competitors follow, otherwise their cost structure is out of line.

But what of the second-order effects? Chewing gum sales have lost 15% of their volume since the introduction of automated checkouts in the US. The checkouts have disrupted the business model of impulse purchases. People do not drive to the supermarket to buy chewing gum, but when you used to stand in those checkout lines, you would pick up some chewing gum. I think mobile phones have had a bit to do with it too, because you now do other things when you're standing there.

Our job as fund managers is to try and spot the next Wrigley. In 1999, at the peak of the technology bubble, Warren Buffett was asked by a group of students why he doesn't invest in technology. He said he could not predict where the internet was going but investing in a business like Wrigley will not be disrupted by technology. And look what's happened. Wrigley sales had gone up for 50 years, every year, before this change happened.

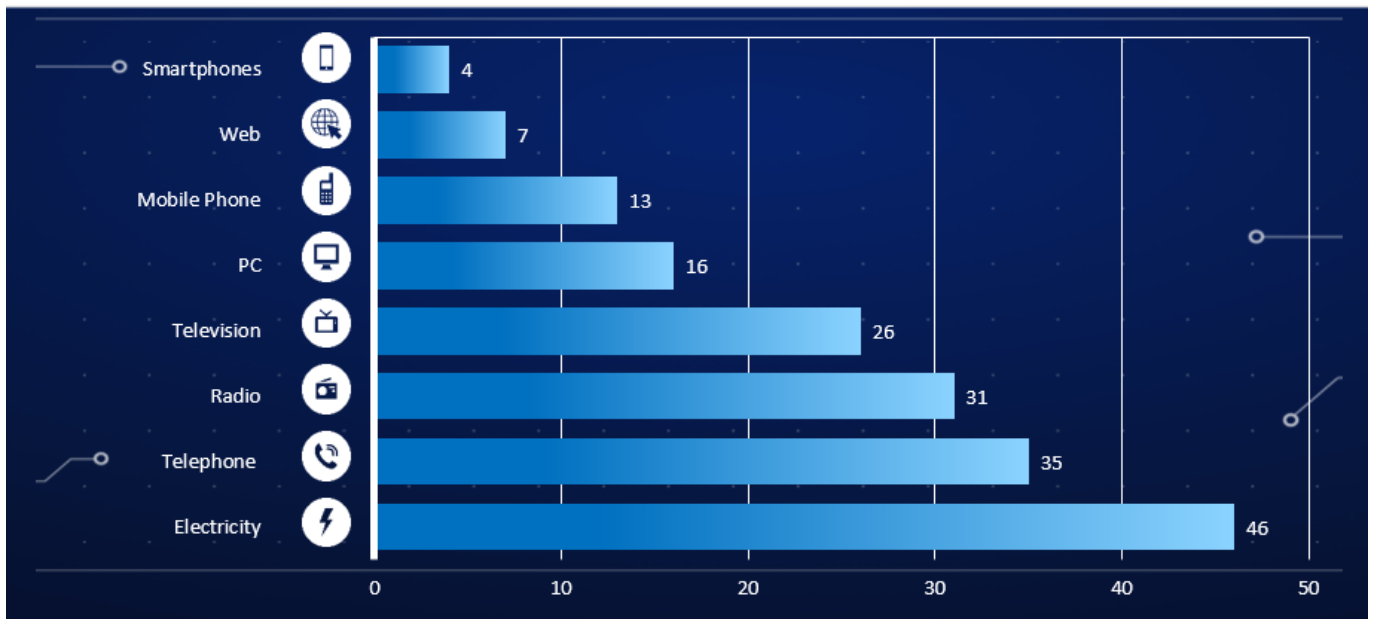
The pace of change is accelerating

Technology adoption appears to be accelerating. The chart below shows the number of years it takes to reach 50 million new users. We saw the rapid adoption with smart phones, and it only took Facebook five years to move from 1 billion to 2 billion users. These new technology-related businesses can scale at an incredibly fast rate.

I think there's a whole series of factors explaining why this is happening, and a lot of things are starting to come together.

First, globalisation and the internet have enabled products to spread rapidly to much larger audiences around world. A second factor is the digitalising of goods and services. We have digitalised books, newspapers, music and videos. With Facebook, Google or Netflix, all their services are digital goods. Instead of spreading atoms around the world, we're now spreading bits around the world where an identical copy of a digital good is produced at zero cost.

Technology Adoption is Accelerating



Source: U.S. Census, Wall Street Journal

Third, the mobile phone today is more powerful than the world's most powerful super-computer in 1986, in the year I left school, which is absolutely incredible. And now we're connecting all these devices in 'cloud computing', where massive data farms don't need computers to sit locally, and you can share all this information. So there's a whole lot of infrastructure and change that's enabling very rapid change.

The incredible power of two digital platforms

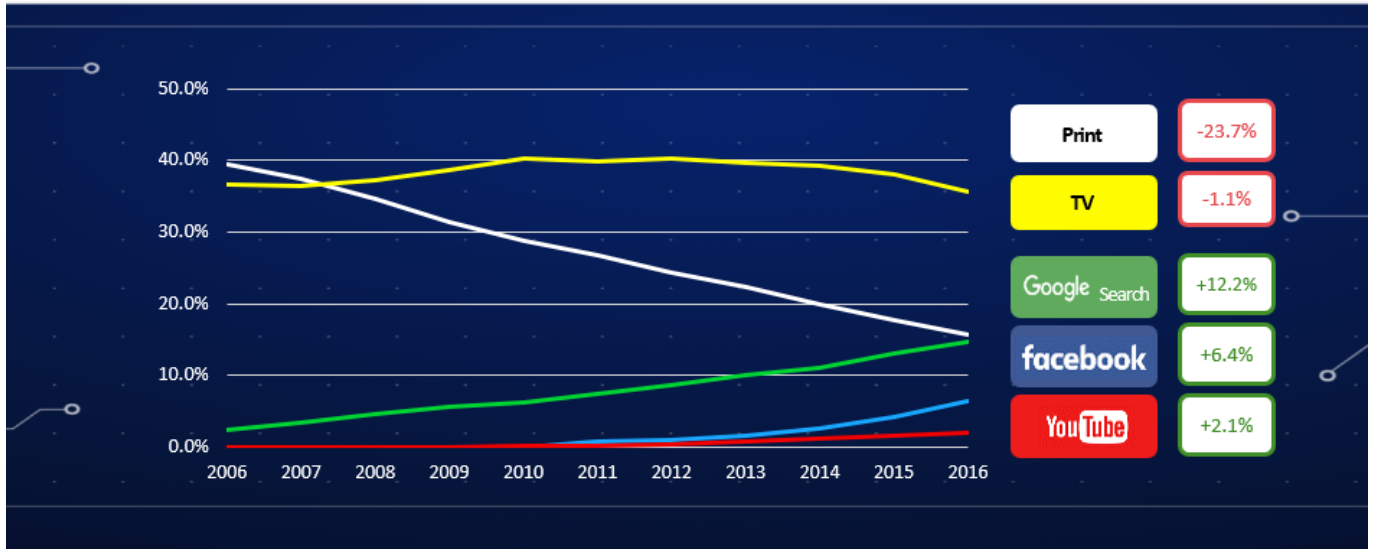
Consider the 'GAF effect' from Google, Amazon and Facebook. I don't mean specifically those companies, but how they are affecting industries and important business models. First is the advertising industry. Google and Facebook know an enormous amount about their users. Anyone who uses Google has something called a Google timeline (unless you've opted out of it). On your Google timeline, in your user settings, you can go back five years and it will tell you exactly what you did five years ago if you carried your mobile phone, and most people do.

It tells you what time you left your house, whether you walked to the bus, which bus you boarded, if you went to work or not because it knows the address. If you take any photos on a day, it will put those photos on the timeline. It will tell you where you went for lunch, when you went home and if you went to dinner, it will tell you the restaurant. And this goes for every other day of your life for the last five years. It's collecting enormous amounts of data about you, as are Facebook and others. That enables these platforms to start highly-targeted advertising and make it incredibly efficient.

In the last decade, traditional print advertising has lost about 24% market share, and I predict this will go to zero. It is extraordinary that outside China, two companies (Facebook and Google) have taken nearly the entire market share of a global industry that had many, many players in the world – magazine producers, newspapers producers, classifieds producers. All this revenue has ended up with two digital platforms that have this massive network effect. Television advertising, which is the largest pot of advertising money, has not yet been disrupted. We're starting to see the rise of YouTube but it is still relatively small, as shown below. It's probably got between US\$6-8 billion of revenue at the moment, but it's an industry with US\$150-180 billion of revenue outside China.

What's happening in the advertising market?

2006 - 2016 Global advertising market share (ex-China)



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Television is next

The television advertising business model is the next to fall due to two big factors. We're experiencing the rise of these streaming video services. Think of Netflix, Amazon Prime, Stan, and Hulu, and Apple wants to enter this game. These businesses are spending enormous amounts of money on content creation. Amazon and Netflix this year will spend US\$10 billion creating original content. They are far outspending anyone else on the planet. Facebook just bid US\$600 million for the Indian cricket video streaming rights and were outbid by News Corp's Fox. I think that's one of the last-ditch efforts to protect sporting rights and there's a battle going on between the television and the movie networks. Apple and Netflix are bidding for the next James Bond.

They are taking viewers away from television and pay TV which reduces advertising revenues. Then on the other side, the costs of producing the content and buying the best shows is being bid up. It is not a great business model if your revenues go down and your costs go up.

We're also seeing the advent of new video advertising platforms. The streaming services are not advertising businesses, they are subscription businesses. But YouTube and now Facebook (and they've just launched Facebook Watch) are advertising business models, and I believe that a huge amount of the revenues that are currently in television and pay TV are at risk. It's fundamentally different, because this is targeted advertising. These platforms know so much about the users that advertisements can be delivered specifically to what the users are watching on these new platforms.

The television advertising model as it currently stands gives a number of companies in the world a huge advantage because there are massive barriers to entry to promote products on television if you want to advertise at scale. It will be much easier to enter one of these new platforms. You can do very specific programmes if you are developing a new brand on Facebook, YouTube or Google compared with advertising on television.

The Amazon effect

Amazon is a business with an estimated US\$260 billion in sales (including Whole Foods), the second largest retailing business in the world after Walmart. It's a fascinating company. They run a 'first-party' business, where Amazon buys the goods, stores them in their warehouse and then sells them to their users via the Amazon website or mobile apps. Then they have a 'third-party' business called Fulfillment by Amazon, where other retailers put their own inventory into Amazon's warehouse and then Amazon sells that inventory to their customers as well. So customers suddenly have a much greater selection, and Amazon charges other retailers rent for having their goods in the Amazon warehouse, then charges a commission for selling to the user base.

Amazon also is a massive logistics company. They are expanding warehouse space by about 30% a year and they are incredibly advanced from a technology point of view. They have developed with a robotics company

something called the Kiva robot, with about 45,000 of these robots in their warehouses at the moment. Humans are good at putting goods in a package, adding a label and sending them off. But it's inefficient for the human picker to run around the warehouse to find the shelf where that good is stored in these massive, multiple football field-sized spaces. So these robots automatically go around the warehouse and bring the shelves holding the product to the packers.

The loyalty scheme called Amazon Prime started out with two-day free shipping, then same-day and 2-hour free shipping in a number of cities around the world. Amazon Prime members receive free video, free music and free ebooks with the service.

Amazon is also a data analytics company. They understand enormous amounts of information about what the customer wants to buy. Amazon members see web pages that look different to anybody else's. There are 50 million goods available in Amazon so customers receive a particular look into the world.

Amazon's Jeff Bezos wants to fulfil all of his customers' shopping needs. He worked out that if you want to be in their everyday shopping, you need to be in the grocery shopping habit. They started with Amazon Fresh, an online grocery shopping business that's very niche. But if you want chilled vegetables or meats or ice cream, it's inconvenient to have them delivered on the verandah if you're not there for two hours. A lot of people want to look at their fresh fruit and vegetables and not have anyone else choose that for them. So Bezos bought Whole Foods, the largest fresh food retailer in the US. It had a reputation for expensive produce, lots of organics, incredible displays. On the first day Bezos took control, on the key lines people are interested in, he dropped the prices 35-45%. People shop for incredibly good, fresh groceries then everything else can be put together.

He wants to connect your home by the 'Internet of Things'. Many goods like washing detergent and milk will have computer chips on them that will connect to the internet to know when you are running out. Washing machines and fridges will automatically generate shopping lists. He's adopting a voice platform for your house with a digital personal assistant.

What's next?

There's a massive number of these revolutions. You may think Amazon and Facebook and Google are big at moment, but we're in the early stages of where this technology and these businesses are heading. Advertising and retailing is the start. In [Part 2](#), I discuss which large companies will suffer, and bring in the perspectives of Warren Buffett and Charlie Munger.

Part 2

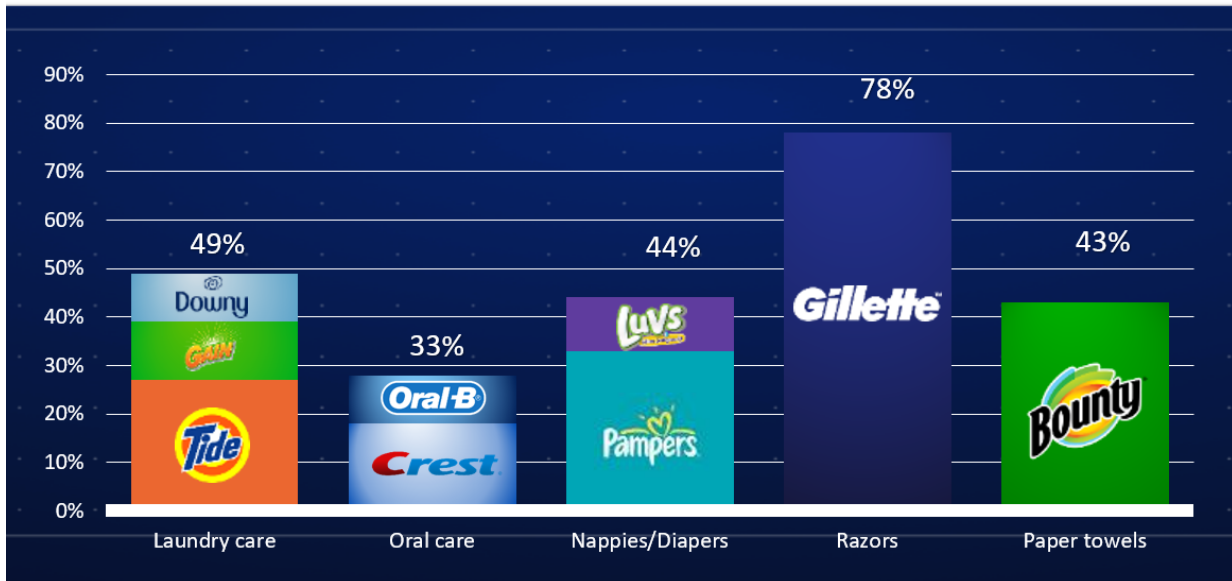
In Part 1, I examined how the advertising and retailing world is changing, driven by new technologies and especially how much Facebook, Google and Amazon know about their clients.

Let's look at the world's largest consumer products company, Procter and Gamble. The goods they sell like Gillette, Olay, Pantene and many of their other products are in our daily lives. P&G is the largest television advertiser in the world, and this is a part of their business model. There are huge barriers to entry into television advertising and you can own a share of mind of consumers. Tide is the largest laundry detergent in the US. P&G needs to convince consumers that when they stain a shirt, Tide is the one that's going to take the stain out, and that's the role of traditional advertising.

Wonderful businesses for 50 years

When you walk into a Walmart store, there are 25 metres of an aisle with the Tide laundry detergents seen on television. It's a massive visual of those products and it receives huge turnover for the supermarket. They win because they are getting the velocity, the advertising businesses get their advertising revenues, and P&G has a business with the most dominant brands in its categories in the US.

P&G - Dominant US brands



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In laundry detergents, adding all P&G's brands, they have 49% of the US market. In oral care, they've got 33%, but it's a duopoly. The other is Colgate, and between the two, they have 80% of the market. We could go through nappies, razors, paper towels, shampoos and other things where dominant companies use traditional forms of advertising and traditional forms of retailing to create high market shares. These businesses have been wonderful businesses to invest in for the last 50 years. Think of Nestle and other big brand-owning companies over the world. And Magellan has owned a lot of these companies in the past as well.

Now let's think about a weekly shop that Amazon's Jeff Bezos has in mind using the Alexa digital assistant. It can order regular items that are running low, but whereas it knows you previously bought Tide washing detergent, Fairy dishwashing tablets and Charmin toilet paper, it can suggest Amazon products to replace these brands. The Alexa platform is already operating in the US. If you ask Alexa to order a battery for your torch, the only batteries it will offer you are Amazon-branded batteries.

It's hugely disruptive when these new technologies affect the brand-owning companies. A company like P&G is not about to go bankrupt, but the future is much less rosy. Their rate of growth will dramatically slow down as they lose volume, and there will be more price competition because the home products will be sold at lower prices and at great quality.

A serious challenge to mean reversion

I'm a quality and value investor, and P&G on average over time has traded at around 20 times earnings. So when P&G trades at 15 times earnings or less, in the past I would have thought, "Well I know they've got dominant brands, I know their business model is robust" and I would probably have bought P&G and then patiently held it. I expected its multiple would probably go back to its long-term average, and I'd earn excess returns. If it was trading at 24 times earnings, I'd know it's probably going to come back to 20 times earnings so I'm probably not going to own it at that point in time.

The mean reversion process of looking at past behaviour which meant buying at 15 times earnings as it is likely to trade at 20 times earnings in the future and deliver excess returns. Now, I seriously challenge whether that's going to work into the future, even when investing in something that's high quality with a robust business.

We're talking about disrupting some of the world's highest quality companies. I'd probably add something like a Bitcoin and other fintechs into the threats that banks need to be thinking about.

So what are some of the experts saying about what's going on with big consumer companies?

Warren Buffett and Charlie Munger on disruption

At the 2016 AGM of Berkshire Hathaway, there was a fascinating interaction between Charlie Munger and Warren Buffett:

Munger: "A lot of great businesses aren't quite so great as they used to be. The packaged good business of the P&G and the company General Mills, they're all weaker than they used to be at their peak, and the auto companies, I mean, when I think of the power of General Motors when I was young and what happened, they wiped out all the shareholders. I would not have predicted that. When I was young, General Motors loomed over the economy like a Colossus. It looked totally invincible. Torrents of cash, torrents of everything and it learned to hold down market share because they were afraid they'd be too monopolistic. Yes, the world changes and we can't make the portfolio change every time something is a little less advantaged than it used to be."

Buffett: "But you have to be alert, thinking all time to whether there's been something that really changes the game in a big way and that's not only true for American Express, that's true for other things we own, including things we own 100% of. And we'll be wrong sometimes. We'll be right sometimes, we'll be wrong sometimes, but we'll be right sometimes too. But it's not that we're not cognisant of threats but assessing the probabilities of those threats being a minor problem or a major problem or a life-threatening problem. You know, it's a tough game but that's what makes our job interesting."

These two are absolutely incredible. Warren's just turned 87 and Charlie's 93. I'd love to be doing this when I'm 87. Warren was saying that assessing the probabilities of these threats is key and you need to then ascertain whether the threat is minor, major or life-threatening, and I think that is really our job. It's easy to get caught up with these changes but you have to think about the probability of some of these changes and over what time frame. A technology like a driverless car, which I think is a very high probability over a 10-15-year period, it's going to have a life-threatening impact on a lot of automotive manufacturers. People will start sharing car fleets so they don't need to own their own cars.

Portfolio positioning in the face of change

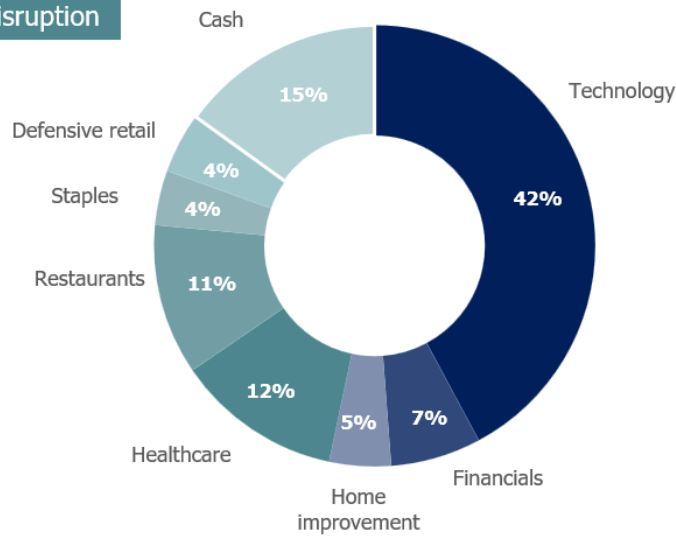
P&G will not go completely out of business but new technology will change the value of P&G. The stuff that's starting to happen will have modest impact on a business like that, and I need to reflect that into the valuation.

With technology, we'll have more deflationary effects in the world. If I took a 10-15-year view, I expect a lower long-term interest rate view. Technologies such as AI, new forms of manufacturing, 3D printing, driverless cars – I won't go through them all – could be massively disruptive to the inflation curve. In the next few years, we'll probably have a headwind of rising interest rates, but in the long term, we could have interest rates coming down again. That's exercising a lot of our thinking.

I'll finish with a couple of slides showing how we have positioned the portfolio to meet these challenges, and the particular companies we believe are best-placed.

How are we positioned?

Defensive
Cautiously positioned around interest rates and disruption



Offensive
42% in global technology, yet well diversified

Technology platforms: 22%

- Consumer
- Advertising
- eCommerce

Payments: 12%

Enterprise

Data as at 30 June 2017.

Navigating disruption

Technology winners

Consumer tech platforms 22%



Payments 12%



Enterprise software 8%



Low risk of disruption

Quick service restaurants 11%



Insulated retailers 7%



Hospitals 3%



Source: Magellan Asset Management Limited. Data as at 30 June 2017. Any trademarks, logos, and service marks contained herein may be the registered and unregistered trademarks of their respective owners. Nothing contained herein should be construed as granting by implication, or otherwise, any license or right to use any trademark displayed without the written permission of the owner.

This is an edited version of a presentation by Hamish Douglass, CEO, CIO and Lead Portfolio Manager at [Magellan Asset Management](#), at the Morningstar Individual Investor Conference 2017 on 6 October 2017. Graham Hand attended the event courtesy of Morningstar.

The evolution of Listed Investment Companies

by Chris Stott on August 1, 2013

Listed Investment Companies (LICs) in Australia are going through a renaissance driven by the introduction of FOFA (Future of Financial Advice) and the amendment to the Corporations Act in 2010 allowing LICs to pay dividends when deemed solvent by the board.

This article discusses these topics, the history of the LIC sector and what the future holds for the space.

A LIC is a listed equity fund: a managed share investment fund that is itself a listed share. In Australia there are 61 listed on the Australian Securities Exchange (ASX) with a value of \$20.4 billion. Currently 46 of them are trading below the value of the shares they own, creating a lot of great value investing opportunities.

The first investment trust was launched in the UK in 1868 by Foreign & Colonial. It was the world's first collective investment vehicle and planned to raise £1 million to invest in government stock of foreign countries and colonial territories. In the prospectus it said it aimed 'to give the investor of moderate means the same advantages as the large capitalist in diminishing the risk of investing in foreign and colonial government stocks, by spreading the investment over a number of different stocks'.

Unique structure of LICs

This principle is still the same today. Like unit trusts, LICs are pooled funds invested in a diverse range of shares that are listed on a stock market. But, unlike unit trusts, LICs are incorporated as quoted companies and instead of buying units in a fund, investors buy shares in a company.

LICs are closed end funds with a fixed amount of capital. No one can buy shares in a LIC unless someone else is willing to sell. Therefore the share price moves according to the rules of supply and demand rather than as a direct reflection of the movement in the underlying assets of the LIC. Thus LICs often trade at either a premium or a discount to the value of the assets they own, namely their Net Tangible Assets (NTA).

It is this premium or discount that makes LICs appear complicated. Most investors are familiar with unit trusts, which quote their unit values every day. Investors can buy or sell the units at the stated NTA daily. With LICs, the variance between the value of the LICs assets and its share price is a complication for some, but provides an incredible opportunity for others.

In a market downturn, such as the GFC, investors in a managed fund are likely to sell their units to get cash, forcing the managed fund manager to liquidate some of their holdings to repay the unit holders. This means the manager is selling into a market that has fallen, and may be forced to sell stocks that they believe are cheap. In a bull market, when money is rapidly flowing into managed funds, the reverse is the case. The managed fund manager may be forced to buy shares they know are over-valued as money pours in from investors. This is never the case with LICs. The LIC manager can continue to hold the same portfolio, and is never forced to sell or buy any stock. Their total focus is on managing money for the benefit of all their shareholders — the manager's investment strategy is not dictated by market sentiment or flow of funds. They may start buying in a downturn and pick up some bargains or sell stocks that become overvalued in a bull market. Supporters of LICs argue that the closed end structure enables them to invest more efficiently and outperform unit trusts or other managed funds over time.

Australian evolution and outlook

The origin of the LIC sector in Australia dates back to the 1920s. The oldest investment company that is now listed is Whitefield Ltd (WHF), which was incorporated in 1923, originally as an investor in mortgage loans. Its business has been solely focused on equity investment since 1949, though it didn't list on the ASX until 2 August 1971.

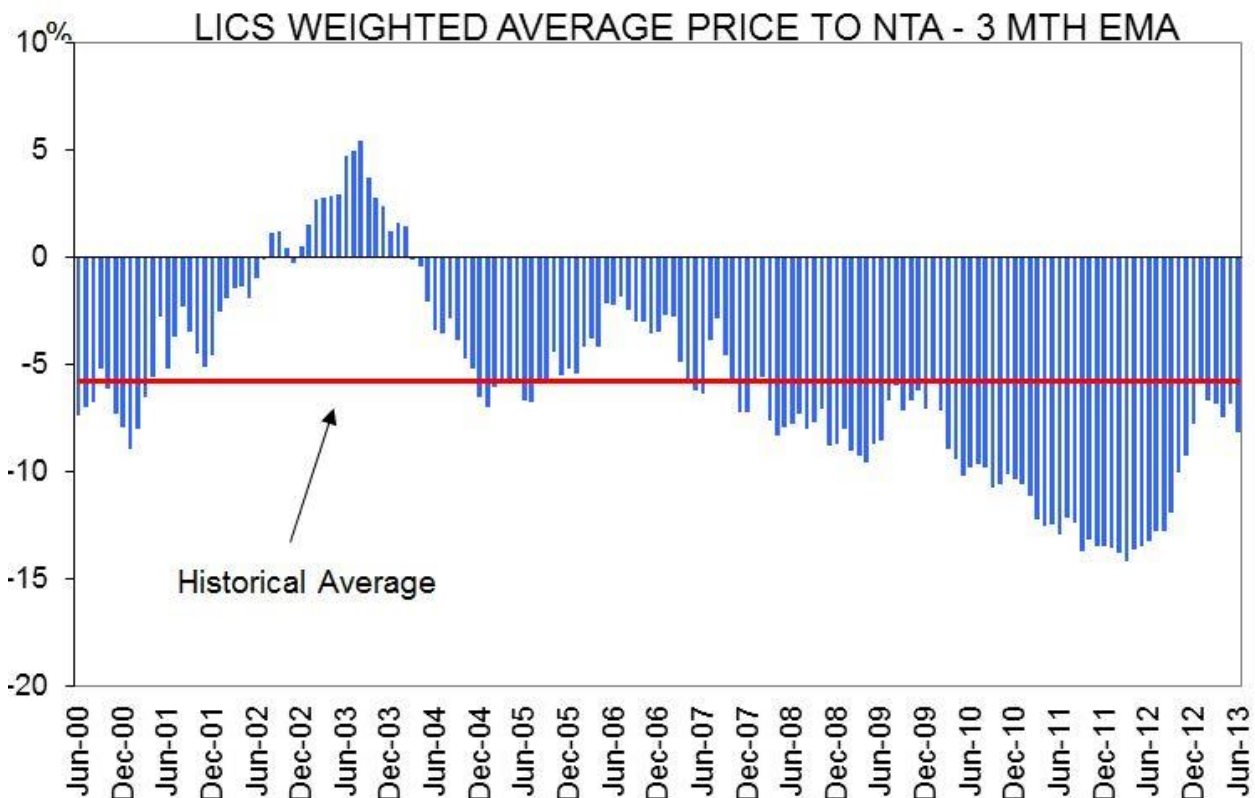
The largest Australian LIC started life in 1928 as Were's Investment Trust Ltd. In 1936 it changed its name to Australian Foundation Investment Trust Ltd and it adopted its present name, Australian Foundation Investment Company Ltd (AFI), in 1938. It listed on the stock market on 30 June 1962. In 1973 it was used to amalgamate

the Capel Court group, which resulted in the takeover of Capel Court Investments, Breton Investments, Clonmore Investments, Haliburton Investments, Jason Investments, Jonathan Investments, National Reliance Investments and Shelbourne Investments. AFIC now has assets of \$5 billion. The second-largest LIC, Argo Investments Ltd (ARG), was established in 1946 and listed on the ASX in 1950. It currently has a market cap of \$4.3 billion.

The LIC sector is currently benefiting from two major structural changes.

The first is the change to the Corporations Act in June 2010, allowing companies to pay dividends as long as they are solvent. Previously they could only pay a dividend if they had an accounting profit, so the company might have had the cash flow, the cash and the franking credits, but if its assets had fallen in value (as happened during the GFC) it couldn't pay a dividend. This is no longer the case. This change in legislation will give companies greater flexibility with dividend payments. Since this change was implemented we have seen several LIC's pay a steady stream of dividends which in my view has helped to narrow the discount to NTA in the last two years.

The second significant structural change is the reform of the financial planning industry. From 1 July 2013, commissions paid to financial planners by providers of managed funds will be banned on new allocations. This will remove a significant impediment for financial planners looking at LICs or other investment products listed on the stock market, such as Exchange Traded Funds. LICs don't pay trailing commissions. For years financial planners have had a significant financial incentive to recommend managed funds, and thus LICs have not fully benefited from the significant growth in the funds management industry. Finally, the playing field will be level. In our business at WAM, we are already seeing an increased level of interest from financial planners in LICs with our funds under management increasing from \$300 million to \$700 million over the last 12 months.



Source: Patersons Securities. EMA = Exponential moving average.

Since these changes were first discussed, the discount to NTA of a number of LICs has decreased. Currently the average discount for the sector is 8.4%. The above chart from Patersons Securities highlights the experience since 2000. To date in 2013, we have seen two successful LIC floats being the Naos Emerging Opportunities Fund and the Watermark Market Neutral Fund. These are the first LICs to make initial public offers since the

GFC, further evidence that interest is returning to the sector. I believe that the momentum gained in recent years has scope to continue given the thematic for the sector.

Chris Stott is Chief Investment Officer and Portfolio Manager at Wilson Asset Management.

Real estate social infrastructure coming of age

by Adrian Harrington on November 19, 2015

Investors are increasingly turning their attention to real estate social infrastructure sectors such as childcare, seniors housing (manufactured housing, retirement villages and aged care), student accommodation, government premises (police stations, courthouses, etc), medical and health facilities as legitimate investment options.

Positive drivers

The growth in real estate social infrastructure opportunities is primarily being driven by:

- demographic and social changes – our aging population is increasing the demand for seniors housing and health services, higher participation of females in the workforce and the growing number of 0-5 year olds is increasing the demand for childcare whilst the rise of international students is one reason the student accommodation market is booming
- the demand for better quality facilities – operators (tenants) and their customers are requiring higher quality facilities. For example, the childcare sector is moving from 'child minding' to early learning which is changing the design and layout of centres away from converted houses, the health care sector is being driven by advances in medical technology and procedures and the aged care sector, supported by government regulation on quality standards, is increasing the demand for higher quality aged care facilities
- government financing and budget constraints – the public sector's ability to fund the level of infrastructure required to meet the needs of the community is under pressure and governments are increasingly seeking private sector participation
- relative high population growth rates and greater density and urbanisation of our major cities – increases the need for investment on social infrastructure assets that support communities both in the inner city and on the urban fringes and
- the growing realisation that operators should focus on their core business – managing and delivering services to the community rather than the provision, ownership and management of the underlying real estate assets.

Drivers add to the investment quality

Real estate social infrastructure is an attractive real estate investment given:

- relatively high yields – social infrastructure assets typically have yields of between 100 and 150 basis points higher than major office, retail and industrial assets
- attractive lease structure – a combination of a long duration initial lease term of circa 10 years plus, inflation protection given rental increases are typically linked to CPI changes and a triple-net structure which means that all capital expenditure and refurbishments related to the asset are paid by the tenant
- stickiness of tenants – tenants are inherently linked to their premises due, in many cases, to the specialised nature of the assets, particularly the internal fit-outs
- strong demand – the favourable demand drivers (noted above) for early learning, health and medical, student accommodation and seniors living

- government support – many of the social infrastructure sectors receive some form of government subsidies or payments and
- the attractive investment characteristics – social infrastructure assets typically exhibit low volatility and generate consistent cash flows as a result of the less cyclical demand drivers, and therefore, offer a low correlation with other asset classes, resulting in attractive diversification benefits for investors.

Risk of investing in social infrastructure

The benefits of social infrastructure assets need to be considered in light of the risks.

The key risk to investors is the specialised nature and often the critical importance of the operator leasing the asset. Owning a private hospital is a highly-specialised asset and having a well-capitalised and competent hospital operator such as Ramsay Health Care is critical. Successful investing in this sector requires a sound relationship between the operator (sometimes a government agency) and the real estate owner and an understanding of the underlying businesses operating within the facility.

Also, social infrastructure sectors to varying degrees have high levels of government regulation and intervention which are susceptible to change. However, this can also be a positive, especially if the government is partially or fully underwriting the cash flows of the sector.

While the increased operating leverage and other industry risks clearly warrant a risk premium, the sectors risk-reward profile has improved greatly as many of these social infrastructure sectors have grown and matured. For many of them, they are no longer a cottage industry. Consolidation of operators in the early learning, health and aged care sectors is well underway. Many of the operators are publicly-listed companies such as G8 in the early learning sector, Ramsay Health Care and Primary Health Care in the healthcare sector and Japarra, Regis and Estia in the aged care space.

Listed and unlisted investment options

There are now five sector specialist A-REITs and four sector specialist real estate developers and managers listed on the ASX providing exposure to early learning, manufactured housing, retirement, aged care and health/medical (Table 1). It is early days, as these entities represent less than 0.5% of the entire listed A-REIT and real estate manager or developer sectors. By way of comparison, social infrastructure real estate represents more than 20% of the market capitalisation of the US REIT Index.

Table 1: ASX Listed Real Estate Social Infrastructure – November 2015

A-REIT	Sub-sector	S&P Sub-sector Classification	Market Capitalisation \$m
Folkestone Education Trust	Early Learning	A-REIT	535
Ingenia Group	Manufactured Housing/ Retirement Villages	A-REIT	410
Arena REIT	Early Learning & Medical/Healthcare	A-REIT	403
Generation Healthcare REIT	Medical/Healthcare & Aged Care	A-REIT	393
Aspen Group	Manufacturing Housing/ Caravan Parks	A-REIT	164
Aveo	Retirement Villages	Real Estate Manager/Developer	1,509
Gateway Lifestyle	Manufactured Housing	Real Estate Manager/Developer	663
Lifestyle Communities	Manufactured Housing	Real Estate Manager/Developer	254
Eureka Group	Manufactured Housing	Real Estate Manager/Developer	124

Source: IRESS

The performance of the social real estate focused A-REITs has generally been positive. The two best performing A-REITs in the S&P/ASX300 Index over the three years to 31 October 2015 were both real estate-related social

infrastructure A-REITs – the Folkestone Education Trust (early learning) and Ingenia (seniors living) with total returns of 30.8% p.a. and 24.7% p.a. respectively, outperforming the S&P/ASX300 A-REIT Index's 16.0% p.a.

The unlisted market is also embracing the real estate social infrastructure sector. Three notable unlisted social infrastructure funds are the Australian Unity Healthcare Fund which owns more than \$760 million of hospitals, medical clinics, nursing homes, day surgeries, consulting rooms, rehabilitation units, radiology and pathology centres; the Folkestone-managed CIB Fund which owns a portfolio of police stations and courthouses leased back to the Victorian government; and the Transfield-managed Campus Living Villages Fund which owns a portfolio of student accommodation facilities in Australia, New Zealand, the US and UK.

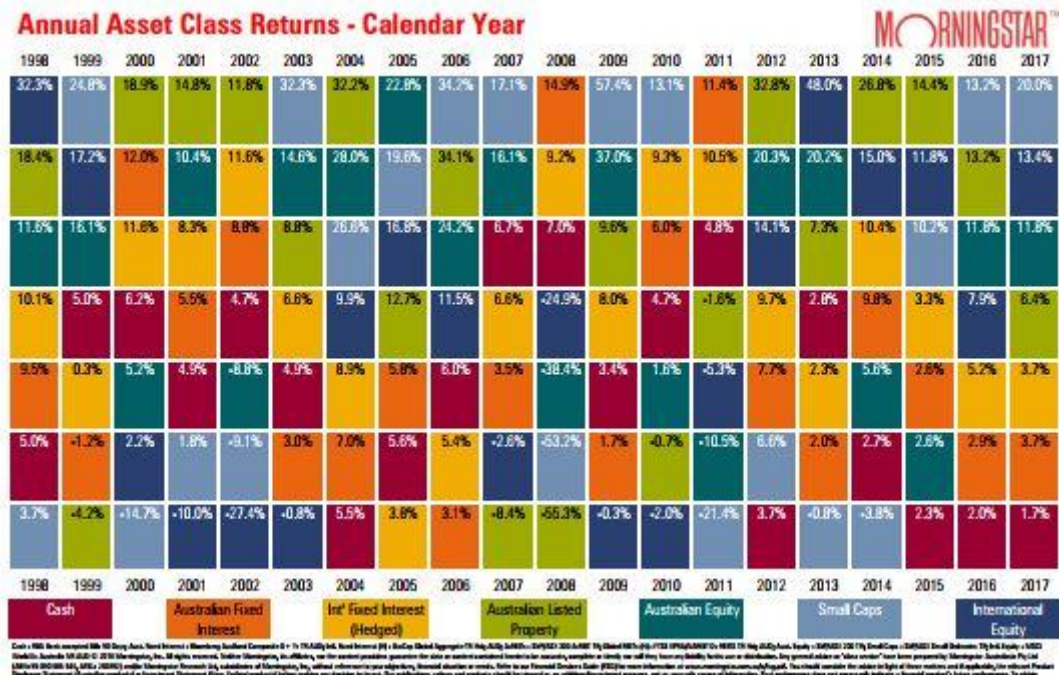
Real estate is not only the big end of town

Much of the real estate media focus is on large office buildings, major shopping centres and infrastructure assets like toll roads and ports. Social infrastructure features solid demand drivers, the evolution of tenants from cottage industry operators and attractive investment characteristics. We expect real estate social infrastructure (both listed and unlisted) to attract more longer-term investment capital and become a viable component of many more real estate investment portfolios.

Adrian Harrington is Head of Funds Management at [Folkestone Limited \(ASX:FLK\)](#). This article is for general education purposes and does not address the needs of any individual.

Morningstar 2017 Gameboard and Peer Group Performances

Morningstar's Gameboard of asset class returns over the last 20 years.



Morningstar Category Averages - Returns to 31 December 2017

Australian Equity and Property Categories % pa

	FYTD	CYTD	1 Year	2 Years	3 Years	5 Years	10 Years
Equity Australia Large Value	6.71	8.54	8.54	9.44	6.99	9.71	4.55
Equity Australia Large Blend	9.02	12.13	12.13	10.44	7.98	9.67	3.54
Equity Australia Large Growth	9.68	13.46	13.46	9.96	8.53	10.35	3.83
Equity Australia Large Geared	15.11	19.19	19.19	15.93	10.39	14.51	-0.08
Equity Australia Mid/Small Value	9.93	12.01	12.01	14.46	14.11	13.33	6.79
Equity Australia Mid/Small Blend	15.86	18.30	18.30	12.97	14.98	11.69	5.27
Equity Australia Mid/Small Growth	16.71	20.06	20.06	13.19	15.28	12.89	5.28
Equity Australia Real Estate	9.13	6.20	6.20	9.35	10.52	12.45	1.63

Click to enlarge[/caption]

Multisector Categories % pa

	FYTD	CYTD	1 Year	2 Years	3 Years	5 Years	10 Years
Multisector Conservative	2.44	3.95	3.95	3.62	3.12	4.11	4.18
Multisector Moderate	2.99	5.28	5.28	4.50	3.79	5.24	4.10
Multisector Balanced	4.58	7.43	7.43	6.55	5.40	7.36	4.31
Multisector Growth	5.99	9.53	9.53	7.88	6.47	8.84	4.11
Multisector Aggressive	7.70	12.24	12.24	10.20	8.50	11.28	4.26

Click to enlarge[/caption]

International Equity Categories % pa

	FYTD	CYTD	1 Year	2 Years	3 Years	5 Years	10 Years
Equity World Large Value	7.65	12.41	12.41	9.92	9.57	15.96	4.23
Equity World Large Blend	8.18	14.75	14.75	10.09	10.29	16.92	5.39
Equity World Large Growth	8.14	17.63	17.63	10.58	10.40	16.42	5.18
Equity World - Currency Hedged	9.76	20.42	20.42	14.24	10.27	14.02	6.41
Equity World Mid/Small	9.30	12.40	12.40	9.97	10.51	18.42	6.95
Equity Emerging Markets	11.30	23.31	23.31	16.53	9.51	9.28	1.74
Equity Asia Pacific w/o Japan	13.00	29.99	29.99	15.40	11.21	13.97	5.11
Equity Global Real Estate	5.40	7.67	7.67	5.55	5.82	9.92	4.52

Click to enlarge[/caption]

Australian and International Bonds Categories % pa

	FYTD	CYTD	1 Year	2 Years	3 Years	5 Years	10 Years
Australian Short Term Fixed Interest	1.09	2.30	2.30	2.40	2.31	2.67	3.71
Bonds - Australia	1.21	3.22	3.22	2.77	2.43	3.45	5.59
Bonds - Global	1.31	3.22	3.22	4.09	3.36	4.36	6.38
Bonds - Global / Australia	1.23	3.15	3.15	3.25	2.71	3.43	5.05
Diversified Credit	1.84	4.27	4.27	4.53	3.60	4.19	4.19
High Yield Credit	2.07	4.98	4.98	5.95	4.55	3.91	5.09
Multi-Strategy Income	1.87	4.58	4.58	4.94	3.38	3.57	4.35

Full report available [here](#) also includes one-year returns for each of the past five calendar years, plus standard deviations (volatility) of returns in each asset class. The latter 'risk' measure is often overlooked by investors who consider their portfolios only in terms of returns.

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