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David Harrison on the hot spots in property

Graham Hand

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.

Graham Hand is Managing Editor of Cuffelinks. [Charter Hall](#) is a sponsor of Cuffelinks. This article is general information and does not consider the specific investment objectives, financial situation or individual needs of any particular person.

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Tech Wreck 2.0 and Debt Wreck 2.0 are coming

Jonathan Rochford

George Bush once [famously mangled the old saying](#), "Fool me once, shame on you; fool me twice, shame on me." It will be embarrassing for investors in the coming years when they realise they've been fooled twice. In both equity and debt markets, investors are buying securities that have identical characteristics to the disasters of the recent past. Whether it's initial public offerings (IPOs), tech shares, housing debt, high-yield debt or sovereign debt, previous booms and busts give a clear guide to what will eventually end badly.

Tech Wreck 2.0 and hope over experience

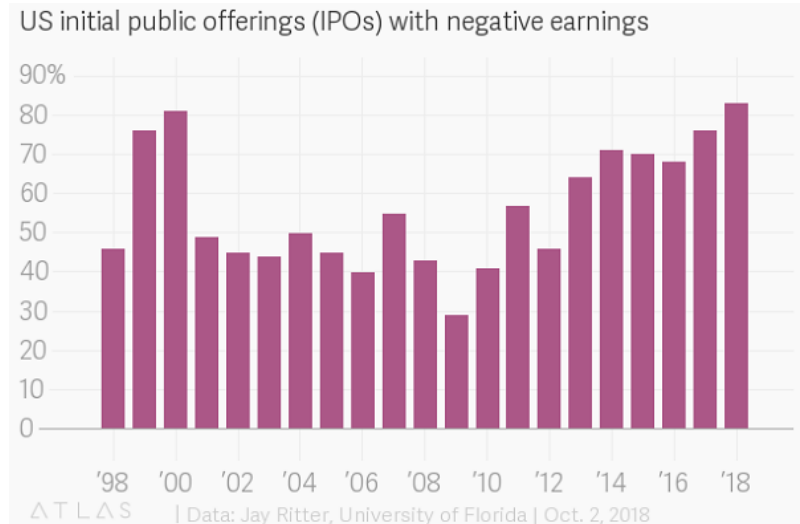
One of the most consistent ways to gauge the bullishness of equity investors is to assess the quality and quantity of IPOs. IPO volumes tend to rise through the cycle, peaking when equity indices are near their peaks.

Those who own and manage businesses are generally well placed to identify when the market will pay them a favourable price.

In 2019, a boom year so far for IPOs in the US will likely make it the best since the record volumes of 1999 and 2000. When private capital raisings are included, the recent spike is even bigger, with venture capital investments in [2018 smashing the record from 2000](#).

A good indicator of IPO quality is the percentage of new issues that are unprofitable. This topped 80% in 2000 at the height of the tech bubble, but this level was surpassed in 2018, as shown below. Buying businesses that lose money indicates investors are preferring hope over experience.

The IPOs of Uber and Lyft this year have both been high profile doozies that sum up the mood. Lyft went first, pricing at \$72 per share and is now trading around \$57. It's larger competitor Uber priced at \$45 per share and is now sitting below \$41. Both companies have a long history of using capital raisings to cover their losses, with no plans to become profitable any time soon. [Roger Montgomery's analysis of Uber](#) is well worth a read, where he says the company has no long-term future. [Harris Kupperman shares the sentiment](#). He posited that Uber's IPO was so big it might have soaked up most of the remaining speculative capital that punts on these sorts of ventures.



Source: [Quartz](#)

Too many similarities with 2000

Two potential future IPOs that look like twins of Tech Wreck disasters are Chewy.com and WeWork. Chewy.com is an online pet supply company that lost \$268 million in 2018 on \$3.5 billion of sales. [It looks an awful lot like pets.com](#), the poster child of the Tech Wreck which managed to go from IPO to bankruptcy in a mere 10 months in 2000. WeWork is an office sub-leasing business that lost \$1.9 billion on \$1.8 billion of revenue in 2018. It looks a lot like the [Tech Wreck office space firm Regus](#), which filed for bankruptcy in 2003.

One of the hallmarks of the Tech Wreck was dodgy financial information and dubious measures of success. Technology companies are often pioneers, whether in the software and services they provide or in their ability to come up with distracting metrics. Some may remember the obsession with 'eyeballs' rather than earnings back in the tech boom days. That sounds an awful lot like the monthly user counts that some investors are religiously monitoring today.

Some of today's tech giants, notably Google and Facebook, have done a great job of turning their huge number of users into advertising revenue streams, leading some to assume that all companies with large user bases will inevitably be profitable. Forgotten is the need for a near monopoly service that competitors can't easily replicate. The likelihood of Uber and Lyft turning out the same way as Google is extremely low as the proliferation of alternative taxi services shows. The inability to turn a profit when scale efficiencies are already substantial is another warning sign.

In order to offer a fig leaf of credibility to their current valuations, many tech companies are creating bizarre financial terms. My favourite is 'community-adjusted EBITDA' for WeWork, which excludes taxes, stock grants, marketing and administrative costs. Tesla has [long been called out for accounting shenanigans](#) with the [regular turnover of its most senior accounting and financial officers](#) another warning sign. Tesla's attempts at disguising its high level of cash burn recently came unstuck. The announcement this month that it would run out of cash in 10 months without radical change has seen its share price sink to almost half the level it was six months ago.

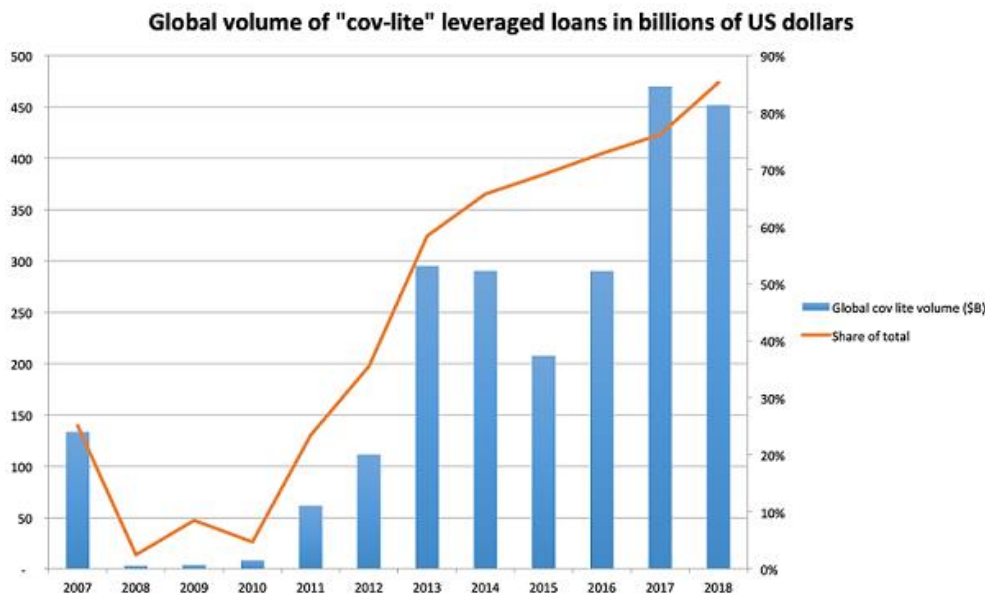
It's only taken 20 years but the hallmarks of excess in the Tech Wreck are in play again.

Debt Wreck 2.0

The low point of the GFC was a decade ago, but lessons have already been forgotten. The debacle that was US subprime mortgages [has come back to life](#) in a smaller way. The US mortgage giants Fannie Mae and Freddie Mac have been busy cutting back on the down payments required and loosening restrictions on the minimum income a borrower needs to service a loan. Lending quality for first-time home buyers [is particularly poor](#). This time around it will be US taxpayers picking up the tab through the government ownership and insurance of the mortgage aggregators.

It's not just the US where dubious mortgages are proliferating. Canada, Spain, several Northern Europe countries and Australia have all been called out for excessively easy housing credit.

Global high-yield debt markets seem determined to go beyond the stupidity seen in 2006 and 2007. The collapse in covenants is a flashing red light that lenders are desperate to push money out of the door on almost any terms. In the lead up to the GFC, covenant-lite leveraged loans were less than 30% of total leveraged loans. Borrowers that were given covenant-lite loans typically had B+ or higher ratings, having some level of inbuilt cushion. Today only the worst of the worst borrowers can't obtain a covenant-lite loan. Holders of covenant-lite loans should expect a slew of their borrowers to slowly bleed to death, with the lack of covenants having cut-off their ability to take early action when the borrower still has some equity value.



Source: [Business Insider](#)

Government debt weaknesses

It's a similar story for sovereign debt as the European debt crisis is likely to re-emerge in coming years. Italy's economy is showing the same signs that Greece did before its ongoing debt crisis, but Italy is almost 10 times bigger. The doom loop of bank failures leading to government failures and vice versa has not been fixed, increasing the risk of systemic and cascading failures. Deutsche Bank's share price hitting record lows shows it remains an enormous risk, but there are dozens of small and medium-sized banks in Italy and Spain that are calling on their governments for additional bailouts.

In the US, a wide swathe of state and municipal governments continue to run up their debts, as well as accruing pension and healthcare obligations. States such as Illinois can add population decline to their list of issues, which reinforces the downward cycle as the smaller remaining population needs to regularly pay higher taxes to cover the increasing interest and pension obligations. The defaults of Detroit (2013) and Puerto Rico (2016) show what lies ahead for bondholders. Heavy debt haircuts will be required to allow these jurisdictions to right their financial position.

Emerging and frontier markets are now showing signs of kicking off another cycle of defaults and restructurings. The last year has seen Argentina, Pakistan and Turkey go from having easy access to debt markets to now needing assistance to meet their upcoming debt maturities. A slew of frontier economies including Iraq and Tajikistan have used the [loose lending of recent years](#) to issue debt despite having obvious challenges in meeting future repayments.

Conclusion

It is often said that those who do not remember the past are doomed to repeat it. Some investment decisions made in recent years bear the hallmarks of the speculative investments made before the Tech Wreck and the GFC. With the recent pullback in several high-profile tech shares, bank shares and the surging yields for a handful of emerging market sovereigns, we might be witnessing the beginning of a necessary and inevitable process of taking out the investment trash.

Jonathan Rochford, CFA, is Portfolio Manager for [Narrow Road Capital](#). This article is for educational purposes and is not a substitute for professional and tailored financial advice. This article expresses the views of the author at a point in time, which may change in the future with no obligation on Narrow Road Capital or the author to publicly update these views.

4 food and drink trends to healthier investing

David Sheasby and Will Baylis

More than ever before, people of the world are keeping a close eye on their diets. Obesity has trebled since the 1970s, conditions such as diabetes and heart disease are rising, and in some high-income countries, life expectancy is flattening out. Food and beverage producers are under immense pressure to reform, both from stricter regulations and consumers demanding healthier choices.

As we consider how shifting health and nutrition trends impact business models, we see four outcomes which present both risk and opportunities.

1. Making food healthier

Taxation aimed at promoting better standards of nutrition has been introduced by dozens of national governments, states and individual cities, especially since 2015 when a damning World Health Organisation report was published.

Much of the focus is on sugar. In Mexico, for example, the world's second-most obese country and where diabetes is the leading cause of death, a levy is placed on all sugary drinks except milk. In the UK, where a new tax on sugar levels was introduced in 2018, more than 50% of manufacturers reduced the sugar content of drinks ahead of its implementation.

Some leading companies have already made big commitments. Britvic, for example, has promised to reformulate its drinks in most countries, cutting sugar content and reducing average calories per 250ml by 20%. Meanwhile, Pepsico pledges to reduce sugar, saturated fat and sodium across many of its food and beverage products as part of its 2025 goals.

2. Right-sizing the product

Where reformulation is not possible, companies are instead focusing on portion size. Drinks manufacturers like Coca Cola (which notably had to reverse plans to introduce a new sweeter Coke recipe in the 1980s) has introduced slimline cans, meaning sugar content for the consumer is reduced with no reformulation required.

However, companies that go down this route have to exercise caution, as such a move could be damaging from a consumer perception that it is simply protecting margins via 'shrinkflation' (where the product shrinks in size but remains at the same price). Confectionary giant Mondelez tried to change the shape of its iconic Toblerone to guard against rising cocoa prices but was forced to change back and put up prices after a public outcry.

3. Transparency and labeling for consumers

A key factor for consumers is wanting more control over the choices they make. Transparency from companies over what their products contain is paramount. Making more information available on the nutritional value of products is an important factor in retaining their license to operate.

Voluntary 'traffic-light' schemes, displaying levels of calories, fat, sugar and salt have been introduced in many countries. Some companies are preempting the changes, such as Danone which is rolling out its 'Nutri-Score' colour-coding system in countries across Europe, even those where there is no labeling system in place yet.

4. Product change to healthier products

Finally, many businesses are making wholesale changes to their product lines to reflect the new environment. As consumers begin to view ultra-processed food in the same vein as smoking, companies are either simply cutting unhealthy products or switching to healthier alternatives.

Britvic, for example, now says 70% of its innovation pipeline is focused on developing low or no-sugar drinks (less than 5g per 100ml). Meanwhile, Kerry Foods has developed four 'consumer nutrition pillars' consisting of 'free-from' foods, diet brands, natural foods and products tailored to particular nutritional needs such as infants or individuals with specific medical conditions like diabetes.

Coca-Cola Amatil, based in Australia, is one of the largest bottlers of non-alcoholic ready-to-drink beverages in the Asia-Pacific region, operating also in New Zealand, Indonesia, Papua New Guinea, Fiji and Samoa. In the Australian domestic market, Coca-Cola Amatil has launched low-calorie alternatives, such as Coke Zero, and innovative sparkling waters to reduce the distribution of products causing obesity and related health issues. They are taking advantage of the growing demand for healthier beverages.

Change in emerging markets is slower

Coca-Cola Amatil's approach to developing markets, such as Fiji and PNG, is however different to that in Australia, with the new healthy alternative not being distributed to those markets due to lack of demand.

Martin Currie Australia initiated discussion with the Coca-Cola Amatil Board in 2018 to enact change. The company has acknowledged the obesity and related health implications from their predominately full-sugar drinks, and they are working with the governments on solutions and further health education.

The investment perspective

The scale of opportunity from an investment perspective goes further than simply food and drink manufacturers. Food technology plays an increasingly important role, and the trend of health and wellness involves science-based companies like the developers of supplements (such as vitamins or flavour enhancers), and probiotics – live bacteria which can help reduce gastrointestinal problems and strengthen the body's immune system.

There are also investment opportunities that provide investors with more control over how their funds are invested. For example, the Legg Mason Martin Currie Ethical Income Fund range explicitly will not invest in companies that are involved in the production or sale of alcohol or tobacco, leading to companies such as Coca-Cola Amatil, Woolworths, Coles, Metcash and Amcor being excluded from the investible universe.

The food and beverage sector is fiercely competitive and many companies are sensitive to both the large shifts in consumer sentiment towards healthy eating, as well as the heightened focus from politicians on nutrition and wellness. In all of our investment strategies, this requires us to look at which companies are successfully tackling the challenge, as well as those that are not. ESG analysis provides a valuable future view on the impacts for companies in this sector, including the opportunities and the threats, and by extension, the winners and the losers.

David Sheasby is Head of Stewardship & EGS at Martin Currie and Will Baylis is a Portfolio Manager with [Martin Currie Australia](#), Legg Mason affiliates. Legg Mason is a sponsor of Cuffelinks. The information provided should not be considered a recommendation to purchase or sell any particular security. It should not be assumed that any of the security transactions discussed here were, or will prove to be, profitable. Please consider the appropriateness of this information, in light of your own objectives, financial situation or needs before making any decision. For more articles and papers from Legg Mason, please [click here](#).

The death of value investing in a low growth world

Jason Orthman and Mark Arnold

Traditional value investing has run its course and it will be ineffective in a low growth, disrupted world. However, good qualitative analysis and the determination of long-term intrinsic value will always remain relevant.

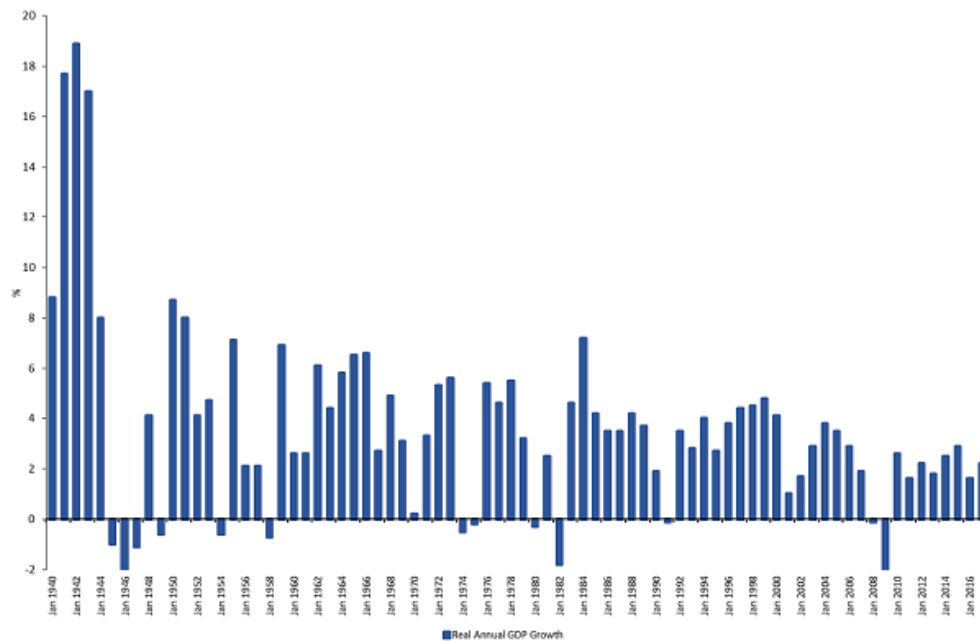
Value investing can be a rational investment strategy, and the so-called 'value effect', or anomaly, has been identified in numerous academic studies. These studies found that buying portfolios of stocks with below average price to book (P/B) ratios or price to earnings (P/E) ratios resulted in alpha generation that could not be explained by the efficient market hypothesis. This hypothesis states share prices reflect all relevant information and it is impossible to beat the market or achieve above-average returns on a sustainable basis.

But times have changed

However, our base case is that traditional value investing will be far less successful in future than it has been in the past. From World War II until the GFC in 2008, we saw a period of strong economic growth in the US and most other major economies, largely attributed to a perfect storm of positive factors:

- low oil prices (except for two relatively short periods from 1974-1983 and 2006-2008)
- the commercialisation of a broad range of technological advances
- a growing middle class (in developed economies up until the late 1970s)
- increasing female participation in the workforce
- young and growing populations.

Figure 1: US real GDP growth was strong from WWII until the GFC



Source: Federal Reserve Bank of St Louis, Hyperion

Traditional value investing relies heavily on finding companies which are themselves heavily reliant on a strong economy to create compounding earnings growth. These types of businesses are more often average rather than high-quality businesses. Quality businesses typically trade at short term premiums to the broader market.

Strong economic growth hides a multitude of business sins

From WWII to the GFC was also a period of benign competitive intensity. Technology-based disruption was low, and average businesses were able to sell average products to middle-income consumers with reasonable success. Many of these businesses lowered their costs by outsourcing manufacturing and other services to low-wage emerging markets. Corporate consolidation was supported by declining borrowing costs, where mediocre businesses had a reasonable probability of being taken over.

On the other hand, when the economy experiences low or negative growth, average businesses tend to suffer disproportionately. Profits of average businesses are leveraged into economic growth because they can usually grow sales organically in line with nominal GDP. With the help of operating and financial leverage, these companies can then grow profits above the rate of sales growth.

Figure 2 illustrates what has happened since the GFC. The value anomaly had largely disappeared and value has underperformed growth since 2007. Lower levels of economic growth have forced businesses to act more aggressively to boost sales, and the general level of technology-based disruption has increased substantially.

Finally, average businesses are usually capital intensive, without substantial pricing power, and therefore need to use debt to boost their return on equity. Many of these businesses were forced to undertake equity raisings during the GFC at low prices, which were highly dilutive to earnings per share (EPS) and portfolio returns.

Figure 2: Russell 1000 Value Index/Russell 1000 Growth Index



Source: Federal Reserve Bank of St Louis, Hyperion

Growth managers have been outperforming value managers for the past decade

According to the 2019 Morningstar Australian Institutional Sector Survey, the average growth manager has outperformed its value counterparts in **global equities** by 197 bps p.a. (1.97%) and 64 bps p.a. (0.64%) over 5 and 10 years, respectively. The average growth manager has outperformed its value counterparts in **Australian equities** by 161 bps p.a. (1.61%) and 107 bps p.a. (1.07%) over 5 and 10 years, respectively.

Traditional value investing generally relies on predicting short-term P/E movements within historically observed ranges. These short-term movements determine whether a company is considered for investment when benchmarked against its comparable 'peers'.

For historical P/E averages or ranges to be meaningful, the underlying earnings and intrinsic value of an average company needs to rise over time, and the P/E ratio needs to mean revert. But for P/E ratios to mean revert, corporate profits need to grow steadily. And for corporate profits to grow steadily, credit and consumption across the economy also needs to be growing as a result of ongoing scale and productivity benefits.

Value investing also relies on the assumption that profits will not decline permanently over time.

Investing in stocks which appear to be cheap because valuation metrics such as P/E ratios are low over an extended time period can, in fact, be what is called a 'value trap'. The value trap springs when investors buy on the basis that profits will lift, and the opposite happens. Companies languish or drop further.

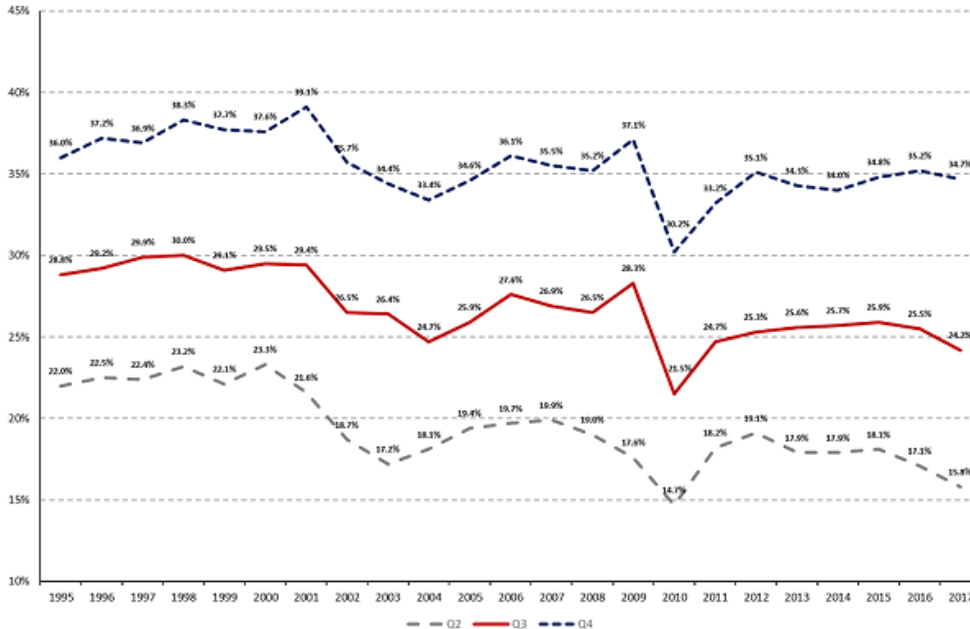
For example, if a stock is trading on a P/E multiple of 12x relative to its long-term average of 15x, a value investor would look to purchase the stock at a 20% discount to its long-term average (for a potential 25% gain), with the expectation that the multiple will ultimately revert to its historical average, and the earnings of the business will also grow in the future.

This P/E arbitrage approach is rational if:

- share prices are rising over time
- the economy is growing in real terms
- the business model, management team or industry structure have not changed structurally.

However, if earnings growth moderates or there is market disruption, mean reversion becomes harder and value traps emerge more frequently as share prices remain permanently depressed. Following the GFC, the return on equity of average and below-average companies has been declining because of increasing levels of disruption as shown in Figure 3 ('quintiles' divide data into five equal parts, so the middle three quintiles remove the best and worst companies from the data base).

Figure 3: Profitability persistence – three middle quintiles (MSCI World Index)



Sources: UBS; Hyperion Asset Management. Note: Operating profitability (OP) equals operating profits (sales minus cost of goods sold minus selling general and administrative expenses minus interest expense) divided by book equity at the last fiscal year end of the prior calendar year.

History does not always correctly inform the future

Historical P/E ranges are not relevant if the long-term earnings outlook of a company is deteriorating through time. This is because the P/E will remain depressed as the earnings outlook deteriorates, resulting in a significantly lower intrinsic value.

In our example above, the correct P/E could in fact be 9x, which would mean a 25% decline in share price rather than the anticipated 25% gain. In addition, if the earnings are declining then the capital loss will be enlarged because a depressed P/E will be applied to progressively lower EPS figures through time.

If the business has significant debt, then the equity value of a structurally-challenged business can quickly decline to zero if lenders get nervous and call in the administrators. Traditional, low P/E value stocks did not provide capital protection in the GFC. Earnings for many businesses proved to be illusory while their high debt levels persisted. Many of these 'cheap' low P/E businesses never recovered.

In a structurally low-growth and disrupted economic environment, we believe simple short-term value heuristics such as low P/E or P/B ratios will not be effective.

For value investing to remain a rational strategy, mean reversion must hold true, and for this to happen, economic conditions need to be supportive or at least steady. And the reality is that historical ranges are no longer relevant to companies losing market share or with fundamentally challenged business models. This is when value traps emerge and share prices can remain permanently depressed.

We believe qualitative analysis is becoming far more important in a low growth world. Attractively-priced companies with the ability to compound earnings and free cash flows over long time periods are the only ones which will generate substantial outperformance.

Mark Arnold and Jason Orthman are the Chief and Deputy Chief Investment Officers respectively at high-conviction equities manager, [Hyperion Asset Management](#). This article does not consider the individual circumstances of any investor.

The flaw in 'value' index funds

Graeme Shaw and Rob Perrone

Value index funds have a fundamental flaw.

The problem is not in the principles of 'value investing'. Those are sound, and they trace back to at least 1934, when Benjamin Graham and David Dodd published *Security Analysis*, where they argue that investors should "be concerned with the intrinsic value of the security and ... discrepancies between the intrinsic value and the market price". Buying stocks at a discount to their intrinsic value makes sense.

For decades, researching companies like this was the only real way to engage in value investing. That changed in 1992, when Eugene Fama and Kenneth French identified the value 'factor' as a source of market-beating returns. If you simply closed your eyes and bought each company that trades at a low multiple of its book value, you could beat the market. Over the very long term, this factor approach to value investing has worked, too.

That didn't escape the notice of index providers and asset managers, who started creating products to harness the value factor. Today, hundreds of billions of dollars are invested in value index funds and value exchange traded funds (ETFs).

The source of the problem

So if the principles of value investing are sound, and the factor approach works too, what's the problem with value index funds and ETFs? The issue is in how the simplest and most widely-tracked value indices are constructed.

The world's biggest value ETFs track major indices such as the S&P, MSCI, Russell, and CRSP. To build their value and growth indices, each of these providers start with two assumptions that have profound consequences:

1. Value and growth are opposites.
2. A stock's weight in the value index plus its weight in the growth index should equal its weight in the 'normal' market index.

Though the shape of the diagram varies, we can argue that the methodology used has a framework that looks something like this:

For each stock, the index provider looks at one or more valuation measures, like price-to-book, price-to-earnings, and dividend yield, and then ranks all the stocks in the universe. The cheapest stocks get a high 'value score' and end up in the top half of the diagram above.

And because many people are interested in growth shares as well, the index providers do a similar exercise with fundamental metrics such as earnings growth. Stocks with the best fundamentals get a high 'growth score' and end up on the right side of the diagram above.

So far, so good. In a simplistic way, we know which stocks are cheap and which companies are good.

Why can't value and growth be friends?

The trouble comes with the next step.

To decide whether a stock should go in the value index, the growth index, or both, the index providers look for purity. Remember, this pre-determined framework sets up 'cheap stock' and 'good company' as opposites.

In a way, pitting value and growth against each other is similar to assuming that the market is efficient. Cheap stocks must be cheap for a good reason, and expensive ones must be expensive for a good reason. You always

How value ETFs categorise stocks



Source: Orbis

get what you pay for, and you always have to pay for what you get. However assuming this sort of efficiency goes against the whole purpose of factor investing!

In their search for purity, the index providers don't just put all the cheap stocks in the value index as you might expect. Instead, the clearest candidates for the value index are stocks that have high value scores *and low growth scores*. **Rather than calling this 'value', you might call it 'value and anti-quality'**. Or 'cheap junk'. These stocks, we believe in quadrant A, are the core of every big value ETF.

The same thing happens on the growth side. Growth ETFs do not just buy the companies with the best growth. They focus on stocks that have high growth scores and low value scores. Growth and anti-value. Expensive quality only – the stocks in quadrant C.

The rest of the shares aren't pure. They're either value and growth, in quadrant B, or neither value nor growth, in quadrant D. These shares get their weights split between the value and growth indices. No stock is left behind!

Strange results

Think for a moment about your perfect stock. For most of us, it would be a profitable, fast-growing company trading at a dirt cheap valuation. In other words, the stock would sit squarely in quadrant B – cheap quality. Buying these stocks is such a good idea that Joel Greenblatt's 'magic formula' book has sold hundreds of thousands of copies. But magic is not what you get in a value or growth ETF.

Instead, you get a bizarre compromise. For the value index, we've identified the cheap stocks, and then *downweighted* the ones with good fundamentals. And for the growth index, we've identified the good companies, then *downweighted* the ones that are cheap. Neither the value nor the growth ETF gets all of the best stocks, and both of them share the expensive junk—stocks that really ought to be left behind. That may be elegant for the construction of an index family, but it is far from ideal if your goal is attractive returns.

The scope of the problem

We can quantify the hit to investors' returns, using factor data from Kenneth French. Here, we've substituted profitability in for growth as a measure of "good companies", but the returns here are highly correlated with those of commercial value and growth ETFs. And while this data is for the US given the longer available history (back to 1963), the same patterns hold for global shares over a shorter horizon.

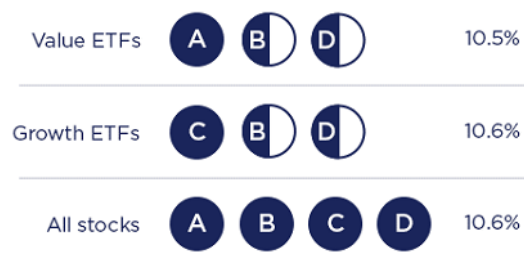
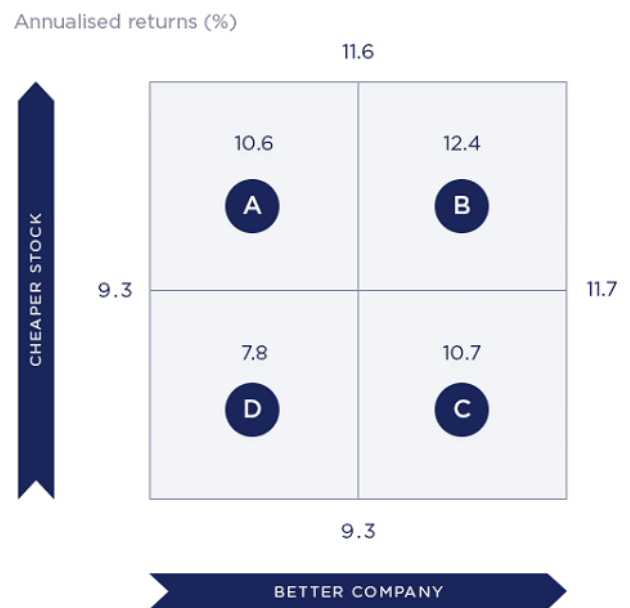
From the numbers, it's clear where you want to be – buying quality at a reasonable price (B) is the clear winner, beating expensive junk (D) by 4.3% p.a. That amounts to a staggering 10x difference in ending wealth over the full 56-year period. But notice that other things work too. If you ignore fundamentals and buy the low-quality stocks (A and D) or ignore valuations and buy the good companies (B and C), you can also get a reasonably nice return. Value works, and quality works.

But as we've presented, you don't get value in the biggest value ETFs. You get value and anti-quality, or cheap junk. And if you buy cheap junk (A) and (1/2 of B and 1/2 of D) or expensive quality (C) and (1/2 of B and 1/2 of D), you get the same return as buying all the stocks in the universe. It's not worth the bother.

Solving the problem

The fundamental problem with value ETFs is that we believe, they target stocks with poor fundamentals. Fortunately, this is a fairly easy problem to solve. Don't be anti-quality, and don't be anti-value. Be pro both. Try to buy good companies at low prices, be patient, and

The scope of the problem



Source: Kenneth French data, Orbis.

Returns calculated using monthly data for US large-cap shares since 1963.

enjoy the rewards. In other words, get back to value investing in its original sense – purchasing companies at a discount to their intrinsic value.

Graeme Shaw and Rob Perrone are Investment Specialists at [Orbis Investments](#), a sponsor of Cuffelinks. 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.

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Did LICs just dodge a political risk bullet?

Dugald Higgins

With the election complete, retirees around the country have claimed victory in opposing Labor’s ‘retiree tax’ on franking credits. Zenith suspects that this may come as cold comfort to those who had already repositioned their portfolios in an attempt to front run the proposed changes given a Labor win looked likely.

During the course of the election, many questions were raised, including:

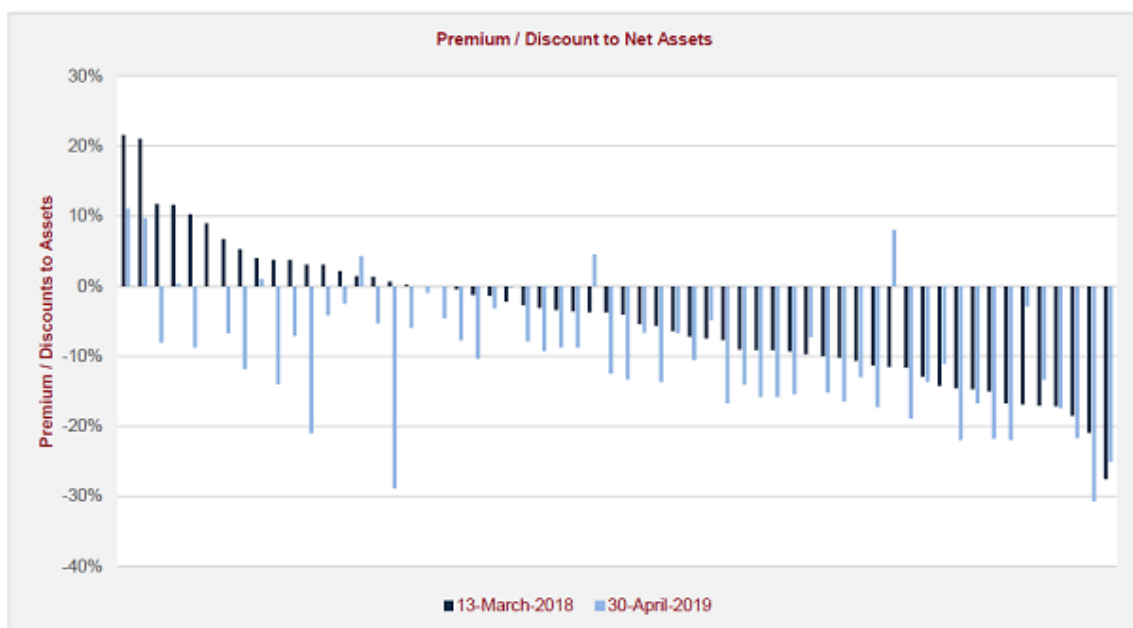
- What is the future of Listed Investment Companies (LICs)?
- Would legislative changes herald the death of the company structure?
- Should LIC investors consider seeking yield from other asset classes or investment structures?

The Labor impact on LICs

Looking at LIC trading as an indicator, market sentiment experienced a decline post Labor’s announcement on 13 March 2018. When measured by their prevailing premium or discount to NTA, the LIC market materially de-rated as investor uncertainty took hold.

Obviously, Labor’s announcement was not the only aspect at play, as the market had already been de-rating some LICs trading at high premiums to NTA (some trading at 20%+). However, the political impact was a factor, particularly given Australian equity LICs had the largest premiums prior to Labor’s announcement.

The following chart highlights this change by comparing each LICs/LITs prevailing premium or discount to net assets as at 13 March 2018 (when Labor’s policy was announced), compared with 30 April 2019. *[Note: we have elected not to label each vehicle as this is less about the individuals and more about the broader trend].*



Source: ASX, Zenith

With Labor losing to the Coalition, we expect some level of positive re-rating for some of the LICs/LITs. However, this raises other interesting questions.

In the run up to the election, many commentators thought Labor’s proposal would ultimately address retirees’ strong home bias, as it meant people would effectively be encouraged to diversify away from portfolios traditionally heavy in fully-franked equities as a source of yield.

But, with investors having just passed through a politically driven near-death experience, how might the search for yield change? Will LICs investing in Australian equities remain attractive as an investment tool?

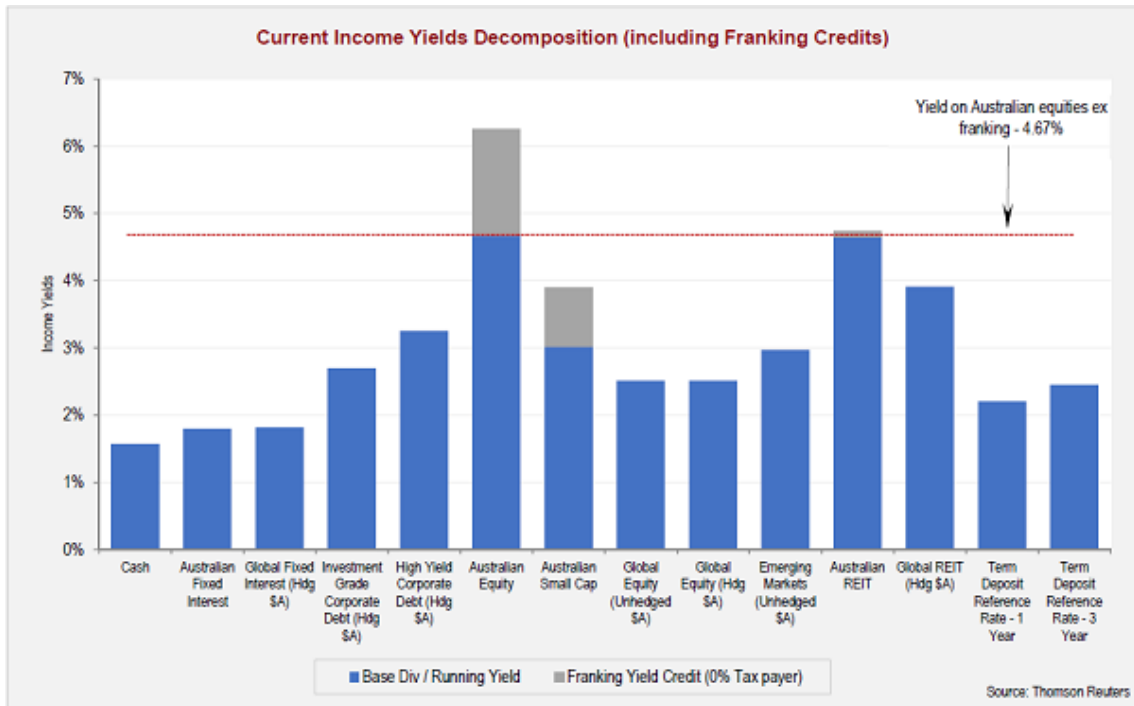
Zenith believes there are two essential elements to consider: the return characteristics of asset classes and the structural differences of utilising a company versus a trust.

Where’s my yield?

Prior to the election, the question uppermost in the minds of those who stood to lose franking credits (i.e. 0% tax payers) was where to find replacement income. The realistic answer is that this was not easily done without making major compromises to asset allocation.

[Note that for the purposes of this report, we are not considering other structural avenues such as changing to industry funds].

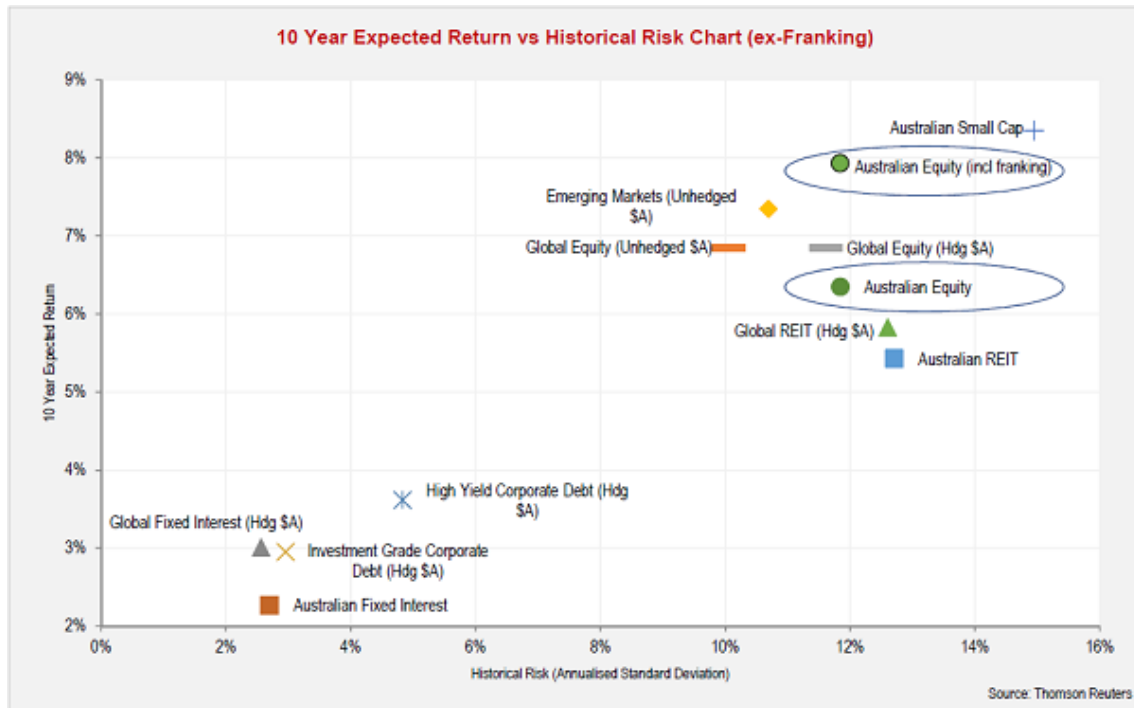
The following chart summaries current yields available from various asset classes as at 30 April 2019.



Australian equities have traditionally been a high-yield investment. While this has been driven in part by the taxation perspective, Australians have long expected to derive income from equities. However, even when removing the impact of franking credits, Australian equities are still one of the highest-yielding assets classes which are available in a liquid, diversified format.

While listed property in the form of Australian REITs runs a close second when removing tax implications, a major shift into REITs is unlikely to be conducive to adequate risk management and portfolio diversification. In sidestepping the franking issue, other investment risks come into play.

Based on Zenith’s long-term market assumptions undertaken by our portfolio consulting team, the long-term expected returns versus their historical risk levels is shown in the chart below for the major liquid asset classes.



From a portfolio construction perspective, lowering the returns available from Australian equities by removing franking would have reduced their allocation in portfolios from an optimisation perspective (the impact of lower returns for the same risk). While feasible, this has two glaring outcomes. Firstly, substituting other asset classes simply introduces other risks and secondly, it still fails to address the question of replacing income for current retirees.

Investors could also invest in other income-producing securities. Some private markets such as real estate, infrastructure and credit can also deliver stable yields at attractive levels. However, is that the right move? Ultimately, Australian equities still hold a key position across the asset classes from a yield perspective.

For LICs, it would be reasonable to expect that this will continue in the foreseeable future. So, the next logical question is, does the structure of listed vehicles have a bearing on income generation?

LICs or LITs? Which works best?

The rise of Listed Investment Trusts (LITs) has been a relatively recent phenomenon, brought increasingly into focus as the arguments around franking mounted. The key difference between the two structures is the way income and capital gains are treated.

For LICs, under the company structure, dividends and capital gains are treated as income, contributing to the profit and loss position. The company pays tax on earnings and pays dividends (franked or unfranked) at the Board's discretion. A company can elect whether to pay dividends and can smooth cash flows using retained earnings from one year to the next. The company may choose to decrease the volatility of the income stream to investors. This has traditionally been a highly-attractive feature of LICs when dealing in an inherently volatile asset class like equities, provided the earnings (retained or otherwise) are there to fund dividends.

As trusts, LITs distribute all net income in the year received, along with any realised capital gains on a pre-tax basis. The investor is liable to pay tax. As a result, LITs pay no tax and therefore have higher cash earnings to be paid out. However, their income streams are more likely to be unpredictable, fluctuating with the manager's investment activity. While LITs do have the ability to offset these fluctuations somewhat through returns of capital, there is still less control compared with LICs.

Zenith believes that the key determinant of the preferred structure for managers is the asset class, investment strategy and objective. For Australian equities managers, particularly those with high levels of portfolio turnover, a company structure is arguably more conducive to the generation of a stable dividend stream to shareholders.

For asset classes where income generation at the security level is more predictable, such as fixed income, or where assets or strategies tend to generate less income, such as global equities, a trust structure may be more attractive.

Given the position of Australian equity LICs in generating stable dividend streams from an asset class with comparatively high volatility, Zenith believes the LIC structure will continue as a core part of the listed investment market.

However, despite a Coalition victory, the issues around the cost of imputation to the government remains a moral hazard. Zenith believes that all investors, regardless of their current position on the road to retirement, must be cognisant of the consequences of political risk to their portfolios and ensure where possible that adequate planning for flexibility is undertaken.

Dugald Higgins is Head of Property and Listed Strategies at [Zenith Investment Partners](#). This article is general information and does not consider the circumstances of any individual investor.

Why hybrids win from the election result

Christopher Joye

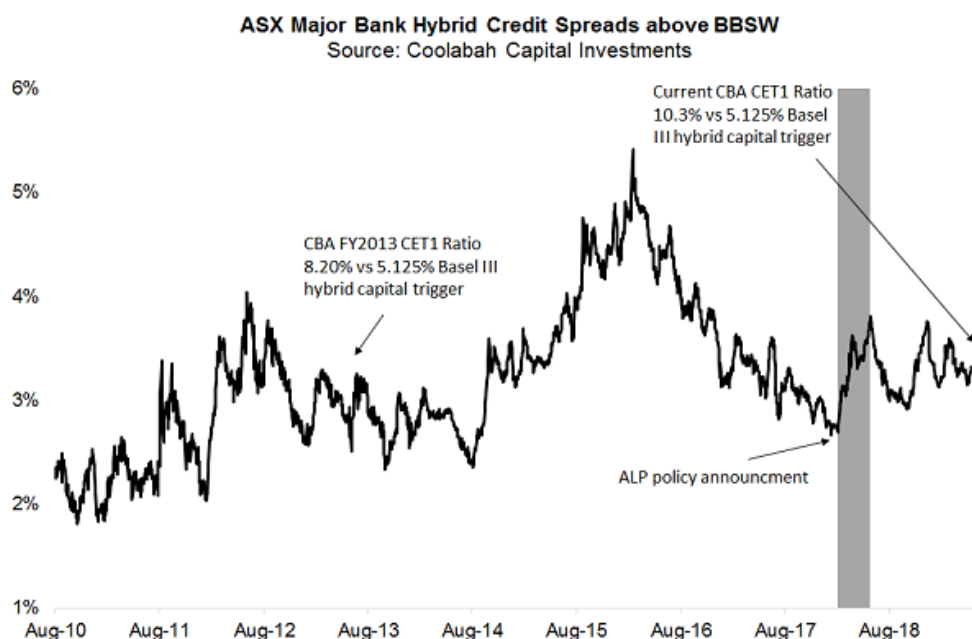
The surprise Federal election result has been positive for hybrids, and good value appears to remain in this sector. The market’s overreaction to franking credit fears, moreover, highlights the benefits of active management in this complex area.

Fading overreaction to the Labor Party policy

When Labor initially announced their proposal to eliminate cash refunds on franking credits in mid-March 2018, we estimated that the policy would affect only a small minority of hybrid holders. Indeed, months later this was confirmed by Morningstar research, which estimated that only 10% to 20% of investors would be impacted by the policy.

Our assessment was that as most hybrids would likely end up in the hands of investors who could still continue to fully utilise franking credits, they should suffer no real valuation or price effects over the medium term.

Despite this assessment, the hybrids market did undergo waves of selling between March and May 2018. As seen in the chart below, this pushed the interest rate spread on 5-year major bank hybrids over short-term market interest rates (technically, the bank bill swap rate or ‘BBSW’) from around 3% to 4%.



At Coolabah, as manager of the [BetaShares Active Australian Hybrids Fund \(ASX: HBRD\)](#), we 'faded' this move, increasing HBRD's portfolio exposure to hybrids. As it turned out, major bank hybrid spreads eventually normalised back down from 4.0% to 3.25% above BBSW by September 2018, helped by an absence of new issuance due to these more expensive hybrid funding levels. We used this opportunity to sell back the extra hybrid exposure we had accumulated during the market sell-off.

We have since made several adjustments to our hybrids exposure when we have considered shifts in market pricing to have been advantageous.

Coming into the May 2019 election, for example, 5-year major bank hybrid credit spreads had once again widened from around 3% above BBSW in January 2019 to 3.55% leading up to the election, reflecting fears that the Labor Party would win and restrict the availability of franking credits.

Coolabah's analysis suggested otherwise. It determined there were two more likely scenarios.

First, we considered there remained a good chance the Coalition would win, based on the view that sheer self-interest would drive voters away from Labor. We also felt that in this new digital age where privacy has become a paramount issue, polling results had proven increasingly unreliable, as shown by the Brexit and Trump campaigns. Respondents are less comfortable sharing their private views with complete strangers.

Second, even if Labor did win, key independent Senators holding the balance of power in the Senate appeared to be opposing its franking policy.

Either way, it seemed to us investor fears with regard to franking credits appeared overblown.

In the month or so before the election, we bought an extra \$100 million of ASX hybrids across all its portfolios and lifted HBRD's portfolio weight to the sector to close to 90%. With the Coalition election win, the 5-year major bank ASX hybrid spread has quickly narrowed back to 3.37%, and our view is that this should compress further towards the January levels around 3.0%, providing further upside potential.

Hybrid outlook

More generally, as evident in the chart above, while the major banks have been boosting their equity substantially, with CBA's common equity tier 1 (CET1) ratio rising from 8.2% in June 2013 to 10.3% in June 2018, the credit spreads on hybrids have drifted wider, not tighter, in recent years.

Reflecting the apparent improvement in relative value, this may explain why institutional investors are increasingly gravitating to the hybrids sector, such as the \$60 billion Unisuper reported to have invested \$300 million in the latest NAB hybrid in February 2019, and having committed about \$1 billion to major bank hybrids in 2016.

As banks continue to de-risk their business models by selling non-core operations and focusing on their core savings and loans activities, we see no reason why major bank hybrid spreads should not compress to levels observed in 2014 and earlier, which implies credit spreads of less than 3.0% above BBSW. This would drive substantial total return performance.

What's more, what the Coalition victory assures is that no political party is likely to ever mess with franking credits again. This means retirees should be able to comfortably claim their cash refunds on franking credits in perpetuity. Over time, this should see advisers and brokers who encouraged clients to sell hybrids over the last 14 months to re-embrace the sector.

Since inception in November 2017 to 30 April 2019, HBRD has returned around 5.1% per annum net of fees on a franked basis. It is diversified across 40 different bonds and hybrids with an estimated gross portfolio running yield of 5.12% as at 20 May 2019*.

All investors should note that hybrids are relatively complex securities that combine elements of debt and equity securities. Further details on the features and risks associated with the HBRD Fund are available [here](#).

*Christopher Joye is a Portfolio Manager with [Coolabah Capital Investments](#) and the investment manager of BetaShares HBRD fund. BetaShares is a sponsor of Cuffelinks. This article is general information and does not consider the circumstances of any investor. *Past performance is not indicative of future results. Yield figure is indicative only and will vary over time. Not all investors will be able to obtain the full value of franking credits.*

What now for SMSFs and hybrids?

Campbell Dawson and Norman Derham

Well, that was unexpected. The election delivered a revolt against Labor's franking credit policy. Prior to the election, we thought there would be little influence on the hybrid market because there was sufficient demand outside the affected investors to soak up the next few years of supply. If and when SMSFs did react to the policy, their biggest issue was their franked equity portfolio. Equity allocations are much larger in most SMSF portfolios.

At time of writing, the bank component of the Elstree Hybrid Index is up around 0.5% compared to the 9% increase in the S&P/ASX200 Bank Index. The hybrid return is only just in the top 5% of two-day returns over the last 10 years. Given that the election outcome was clearly unexpected, it indicates there are not yet a lot of pension SMSF investors returning to the market.

Ignore us and think long term

When it comes to hybrids, investors should consider our short-term guesses as next to useless for the simple reason that we believe hybrids should be a component of most income portfolio. Investors should be insensitive to 1%-2% price movements because of the favourable characteristics hybrids bring to portfolios:

- Cash rates are going to 1% and term deposit rates will be around 1.5% in a few months.
- The hybrid return of cash rates +3% or so is close to equity market returns over the long term and equivalent to income returns from high yield bonds or loan funds.
- Hybrids are not volatile except in big equity market drawdowns. Since the GFC, we've seen 20% decreases in equity markets and a maximum 3% drawdown in hybrids.
- Hybrid return weakness is short term.
- The risk factors and pattern of returns are uncorrelated to both equities and other income categories. High yield bonds and loan funds are more highly correlated to equities in a statistical and fundamental sense and if (and when) we do get a recession, they are more likely to fall by more than 10%.
- Hybrids are liquid, with a few exceptions. Other higher-yielding income categories have unproven liquidity and are probably lobster pots (easy to get into, impossible to get out of). In stress, they will trade below their doubtful NAVs.

It's worth understanding Sharpe ratios

We'll get a bit techie here, but the concept of risk-adjusted return is easy to understand. You want to earn more for investing in risky investments, if only because lots of volatility upsets investors and they sell at the wrong time. The Sharpe ratio measures the extra return for extra risk and is expressed as a ratio. If it is positive, it means that you have received extra return for the extra risk and the more positive the better. In the chart below, we show the Sharpe ratios for the Elstree Enhanced Income Fund (including franking credits but excluding fees) and the All Ords Accumulation Index over the past 10 years. We use the rolling 3-year ratio as a good timeframe over which to judge investments.



So, what does that tell us?

Since the GFC (when hybrid margins rose from the 1% pre GFC to average about 3.5% since), equities have returned 7.7% per annum compared to the Elstree Enhanced Income Fund (EEIF) return of 6.8% p.a. But because hybrids don't have the annual 10% ups and downs that equities experience, the Fund has a Sharpe ratio of 1, which is twice as good as Australian equities.

Investors considering hybrids should take comfort from the following features:

- Sustainable returns that aren't much below prospective equity returns and well above cash.
- Structurally lower risk than equities, and reasonable prospective risk (although lower than senior debt and subordinated debt in the capital structure).
- Structurally different risk factors than other non-cash and bond asset classes.

Hybrids can be complex in structure and investors should consider the features of any instrument or fund before committing capital, but at least the threat of a removal of franking credit refunds from SMSFs has been removed.

Campbell Dawson and Norman Derham are Executive Directors of [Elstree Investment Management](#), a boutique fixed income fund manager. This article is general information and does not consider the circumstances of any individual investor.

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