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Magellan's Vihari Ross on the players in the team

Graham Hand

Vihari Ross is Head of Research at Magellan Asset Management and a member of Magellan's Investment Committee.

GH: You joined Magellan in 2007. What's the same and what's different over 12 years?

VR: So much is still the same, perhaps because many of us are still here. The big difference is that we have many more people.

GH: But not a massive change overall because the business is so scalable. You're still at only about 130 people.

VR: Yes, but a lot of the additions are outside the investment team. We have many more in sales, operations and corporate advisory that we didn't have at first.

As far as the investment team goes, I don't think Hamish ever intended to run a small business. We never wanted to be in a position where people would say that your performance isn't replicable because you've invested in small companies. We always had a focus on larger businesses and the investment process was set up very early in terms of what we wanted to do.

The focus on downside protection was part of the hiring process with Chris Mackay and Hamish meeting each person. I remember talking about the way I approached investing and they were bringing people in that had a consistent thought process. It was thinking about risk and the distribution of risk along a curve and we were followers of Warren Buffett with a focus on indentifying quality businesses in the first instance.

GH: So you never bought into the contrarian approach to investing?

VR: No, we were looking for quality and we still are today. Completely unchanged. And, of course, the next piece is valuation. We built models and as much depth of work as we could. I started on financial stocks and I remember discovering a huge pool of FDIC (*Federal Deposit Insurance Corporation in the US*) data and it was all free. We were identifying opportunities and checking excruciating detail, including what makes a company a quality business. We have more resources now to access these external data sources.

GH: A lot of fund managers rely on broker reports.

VR: We don't use brokers to a great degree and we do our own work. That's why we have a team of 30 analysts, and each of them covers only six or eight stocks or less if a company is complicated. We try to get to the essence of what makes a company tick.

GH: Hamish has admitted to some mistakes, including Kraft and Tesco. What's the checking process then?

VR: When something goes wrong in a concentrated fund like ours, we spend a lot of time on the problem. With Tesco, the initial error was around business quality and the degree or intensity of competition from the rise of Aldi and Amazon. Eventually, the business turned around but the lesson is that we'd now be less willing to wait around because it was taking up space in the portfolio, or as we say, on the team. Hamish likes the analogy of each company in the portfolio being like the player in a team where each stock has to earn its place.

GH: What's the difference between managing $1 billion and managing $80 billion?

VR: Again, we're doing it in exactly the same way. We've never gone down the company size scale. We always had a focus on liquid, high quality companies trading at a reasonable price. We now have three traders and they are at the coalface of executing the management of the $80 billion.

GH: You must have companies that you like on every other parameter but you can't get enough money into the market to invest in the company.

VR: That's true but we've always had rules around liquidity, so that's not different. But yes, we do find emerging companies but if they are small and illiquid, we don't go there. We also want companies that already have an identifiable moat, not working on building one or where there are significant uncertainties and risk aroung whether they will make it.

GH: You wrote an article recently on the ways the world is changing and especially the projects Google is working on.

VR: Yes, each item I mentioned in the article related to a specific project that is underway. Alphabet's Loon project for hot air balloons intends to deliver wi-fi around the world to even the most remote locations, Verily is a long-term health project with an aim to extend human life, and Wing is their drone delivery service. Better known are Waymo, their automatic cars and DeepMind on AI. It's all part of Google's other bets. Many of these feed off Google's goal of extending the quality of life, not simply prolonging it.

GH: You also wrote that you may invest in companies where the economics are so good, you're less concerned by the quality of management.

VR: My point was that there are high quality companies that are sometimes not being run as well as they should be. For example, McDonald's between 2010 and 2013 was still a good business but it could have been run better. They ultimately fixed it and the underlying economics didn't deteriorate.

Let me answer this way. I mentioned moats, but we also look closely at business risk and the range of outcomes along a distribution curve. Is it a highly predictable, stable business, or is it consumer discretionary which is unpredictable in a recession? Or are there tail risks like Johnson & Johnson getting sued for the talc problem or BP on the oil disaster. Or Tencent, which makes 70% of its money out of online games, facing a freeze when President Xi said gaming is bad for young minds. We focus on how predictable is this business and we need to build conviction. So that's business risk.

The third piece is agency risk. Are management good stewards of shareholder capital including governance and the right incentives, do they have a sensible acquisition strategy? So yes, sensible management is one of our pillars of quality and it's held us back from going into businesses in the past because we just can't get comfortable.

The last piece is what we call reinvestment potential, which is the company's ability to redeploy capital at high rates of return. Some businesses are fine, they don't need incremental capital to grow. It's wonderful. But some businesses like a utility can invest capital and also do well.

We've actually owned most of the things on our menu at different points in time. One we haven't owned is Richemont. It has an incredible brand in Cartier which makes up the bulk of its earnings. It makes 60-65% gross margins and generates strong returns on capital. However, there has been significant risk following the CCP corruption crackdowns in 2013 which materially impacted the watch component of its business and led to a less than rational response from competitors. This has led to a wide distribution and uncertainty about future outcomes. Ultimately, valuation as well as quality and our conviction around that will determine a stocks inclusion in portfolios.

GH: Your main global fund is already concentrated, but now you're launching a high conviction fund. What's the difference?

VR: We've run a conviction portfolio since about 2013, only 8 to 12 stocks, as a distillation of our very best ideas with more flexibility and less rules. For example, it can hold more cash and take more risk.

GH: It feels like it will be quite a ride.

VR: It will be, but deliberately so, and it's for investors who understand that. While it is more concentrated, there is diversification within the thematics of the fund, such as Visa versus Google versus Starbucks.

GH: Many people would consider the Magellan Global Fund is already concentrated with only 20 or so stocks.

VR: Well, maybe this is because I'm a Magellan person, but if you own too many stocks, you diversify your alpha (*extra returns*) away. Our whole process is about best ideas. Hamish always uses the analogy of a football or the cricket team. Every player must earn their place and each player has a role. Someone might be in the team because they can hit sixes, or give huge potential alpha but with more risk. But there's another with less risk who will bat through the innings. They have a wide moat with low disruption exposure and a fewer risks if things go wrong. They contribute to the fact that we always hold less portfolio risk than the market level.

GH: In the past, you have personally specialised in franchises, and some of them now have a bad name in Australia due to doubtful business practices. What makes a great franchise business?

VR: What we call franchises are essentially consumer franchises, and there are two key elements: brand and distribution. That's access to the consumer in one way or another. So it's Yum - which owns KFC and Taco Bell - obviously McDonald's and Starbucks. But we also include fast-moving consumer goods companies like Nestle and PepsiCo, it includes luxury goods and big box retail like Lowes.

But market positions are evolving. For example, historically, large consumer goods companies like Colgate, Procter & Gamble and Kellogg owned many great brands, advertised on nightly TV and then consumers would go to the supermarket which was the only place they bought groceries, and they bought their favourite brands. That reinforced their brand dominance. But now, a big theme is the rise of social media and online shopping. Social media enables challenger brands to come up and disrupt by gaining a following and taking market share and the big brands have in many cases been asleep at the wheel. It's a bit like Oracle saying 10 years ago that the cloud is a fad and now they are investing heavily.

GH: Like Dollar Shave Club initially being ignored by Gillette?

VR: Yes. All you need is an influencer with a million followers to start talking about you. I call them mushroom brands and not all make it but the ones that do are often genuinely good ideas. We focus on which are the truly resilient brands. In the UK, for example, half of all grocery sales are private label but it is a small proportion in the US because Walmart always sold top brands at lower prices. The big brands are squeezed but even more vulnerable is brand number four or five. There's a market leader, a challenger brand, a private label, and less and less room for marginal players.

GH: And tying up distribution as well.

VR: Yes, think of Louis Vuitton. Incredible brand but it also has its flagship stores, its beautiful stores in the best locations around the world and they don't sell their products anywhere else. You get the best customer service and you'll never receive a discount, which is important for brand equity when you're not selling through Nordstrom or Macy's or wherever at 80% off.

Starbucks is a great story of brand and distribution and a growth story with Chinese consumers. It's very difficult to disrupt, they will not be hit by technology, they will embrace it. Now they have a great app for ordering coffee so they keep adapting. Coffee delivery is becoming a big thing. Technology is actually an opportunity. You have to work out if a disruption is more a flesh wound or if it's really going to hurt a company.

GH: A couple of years ago when I would attend Hamish's presentations, there was a very strong interest rate theme. He quoted percentage possibilities of rates rising and possible impact on equity valuations. That seemed to his main concern. Is that history now?

VS: We still use that slide and going into the end of last year, our view was that risks were still skewed to the downside in terms of the potential impact of rising rates. QE was expected to unwind with four Fed fund rate rises over the course of the year. Unemployment was low and there was talk of inflationary risk. There were lots of reasons to hold cash, then January rolled around and the Fed suddenly says, “We’re done.”

GH: Magellan’s Global Fund cash was as high as 20%.

VS: Yes, then in January this year we were in a different world. We changed our view on the probabilities. Where we thought the risk of inflation was 50/50, we were then more like 25% because the economy was still running hard and companies like McDonald's were saying they were experiencing cost pressure. But we changed our model.

GH: And that change included lower rates and generated higher equity prices?

VS: Yes, but not in a universal sense. We have redeployed a lot of that cash and we’re back to around 10% cash. But the reasons for the Fed change also suggest lower growth as the Fed sees a need to keep the current level of stimulus there. What does that mean for some businesses? For some, it means lower growth as well. But we try to reconcile these positions because not all businesses will have lower growth. The way we've redeployed the cash is into defensive equities and not into cyclicals. For example, with consumer staples, their growth comes from people buying food, it's pretty stable.

But in a DCF (*discounted cash flow*) model, if you have a business that’s economically sensitive, you might apply a lower discount rate but you've got lower cash flows as well. In a business that has a resilient earnings profile because it's a staple or has a huge structural growth tailwind behind it, you might apply a lower discount and the cash flow does not fall as much proportionally or at all. You will end up with a higher value in that situation. So it depends on the company whether the lower discount rate feeds into a higher valuation. It's important to not just blindly think everything's worth more.

GH: That’s a really important valuation point.

VS: And remember, we’re looking at a very privileged subset of companies. We're not looking at the battling retailer. Those guys aren’t worth any more with a lower discount rate because they’ve got a lower growth rate.

It’s surprising how resilient TV has been but I think that’s next sector to be disrupted. People now watch news on YouTube or online but it’s not some New Age thing. It’s just the way we are all going about our lives. My son said to me recently, “We don’t watch the news.” And I said, “No, we read it online.” There’s nothing sinister going on there. It's just that it is easier to do it that way, and advertising dollars follow the eyeballs. It's as simple as that.

I consider health and wellness is another disruptive trend. People are living better and it has an adverse impact, for example, on the sales of breakfast cereals but it hasn't impacted the sales of chocolate or crisps because people still want a treat. The stuff that is part of people’s daily rituals, you need to bring the health element into that. So we're looking for structural, resilient growth, like people drinking coffee every day. Will that continue for decades to come? I think so, we’re not going to deny ourselves that.

GH: Last question. Do you feel strongly about a theme or trend which generally the market does not recognise?

VS: We are all about big structural trends, to identify them and be exposed to them and then benefit from the magic of compound interest. We’ve recently spent a lot of time on the Chinese consumer. While it might be well known, it’s underappreciated. Everyone talks about the rise of the middle class, going from 300 million to 600 million over five years. But just as interesting, is the growth in the affluent class of Chinese consumers. Okay, we’re only talking between 1% and 3% of the population, but the numbers are big.

And what are they doing? Drinking premium coffee, buying premium cosmetics, travelling overseas, staying in the best hotels, waering high-end fashion, buying good Australian wine, cognac, Mercedes, BMWs. That cohort has been growing at 30% compound annually. It supersedes the demographic headwind of small families and slower population growth. The Chinese are moving up the income curve and there’s a lot of disposable income. That's capitalism at work. It’s entrepreneurial, capitalist and economics in a fully dynamic way.

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Why you should be wary of share buybacks

Anthony Aboud

Both in Australia and globally we have seen a real step up in share buy-backs over the last few years. With the world awash with capital and interest rates continuing to fall, it becomes extremely tempting for boards and management to justify borrowing money at very low rates and using that capital to buy-back shares.

Like all capital management decisions, the decision to buy-back shares are more art than science. Some buybacks are a good tax efficient way of returning capital to shareholders following an inflow of capital like an asset sale. Using more debt in a capital structure can improve efficiency and return on equity (ROE) which is not a bad thing if the numerator is sustainable.

However, we feel that the short-term share price and earnings per share benefits coming from a buy-back need to be weighed up against the medium to longer term capital requirements. Having a good understanding of the cyclicality of a business, were we are in the cycle, disruptive threats, contingent liabilities, operating leverage, financial leverage and other tail risks is extremely important when making the decision.

Why do the market participants like share buy-backs?

Earnings per share (EPS) accretion

Let's start with a hypothetical example. Imagine a $2 billion (1 billion shares at $2/share each) company which is trading at 15x P/E announces a buyback of 10% of its shares borrowing money at 5% to complete the buyback.

Imagine, for ease of calculation, that this company is ungeared.

	Pre-buy back	Adjustment	Post buy-back
Share Price	$2.00		$2.00
No. of Shares ('000)	1000000	-100000	900000
Market Cap ($m)	2000		1800
Net Debt	0	200	200
Enterprise Value	2000		2000
EBIT	190.5		190.5
Net Int.	0.0	-10	-10.0
Pre-tax Profit	190.5		180.5
Tax (@ 30%)	-57.1		-54.1
NPAT	133.3		126.3
No. of Shares	1000000		900000
EPS	0.133		0.140
EPS Accretion			*5.3%*

Source: Perpetual

Same P/E ratio, share price will rise 5.3%

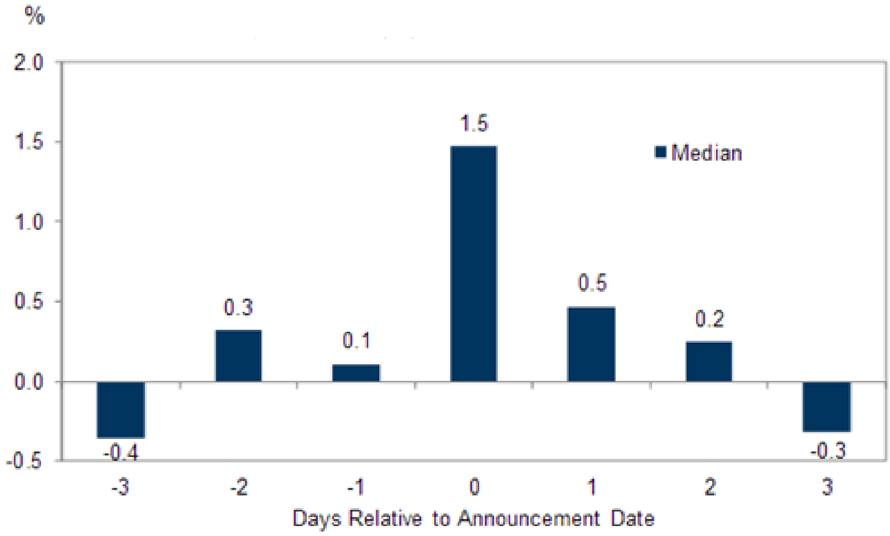
The enterprise value of this company does not change. All that the buy-back has done is to change the capital structure from being 100% equity to having some debt in the capital structure. However, due to the fact that the post-tax cost of interest (3.5%) is lower than the post-tax earnings yield (6.7%), conducting this buyback is earnings per share accretive.

Assuming the company remains on the same P/E ratio, the share price will go up by 5.3% all other things being equal. This magic is why some people refer to buy-backs as financial engineering. It is particularly powerful in the current investment climate where low interest rates make the cost of buybacks cheaper. Given the market is dominated by quants and momentum funds, who place a higher value on companies which demonstrate positive earnings per share momentum, the impact of EPS upgrade is magnified in the share price.

Moving from theory to practice, the market generally responds positively to the announcement of buybacks.

As can be seen from the below chart on the day of the announcement and the proceeding two days the average share price movement for the companies we have analysed in Australia is +2.2%. We believe that is statistically significant.

Price returns around buy-backs announcement



Source: Goldman Sachs

When Lend Lease announced its interim results in February 2018 one of the bullish analysts wrote in his note: "The highlight of the result was the announcement of the $500 million buy-back. While only marginally accretive (c4%), it signals confidence in the cash flows of the business."

Four key reasons cited when companies buy back stock are:

- EPS accretion: As demonstrated above, when the cost of debt is less than the earnings yield, a buyback is EPS accretive.
- Capital efficiency: Often boards justify a buy-back by talking about an efficient capital structure. I am not sure exactly what this is. Clearly, if a board judges that the current earnings are sustainable, and the level of growth capital and innovation spend will be easily funded by the cash being generated by the business, then a buy-back could make sense. However, as we will demonstrate later in this note, short-term capital efficiency targets can lead to poor medium-term capital management decisions.
- Shows the board's confidence in cashflows/valuation: Another positive often touted is that a buy-back gives an indication from the board that they think the shares are cheap and that they somehow have a better view of the cashflows than the market price is assuming.
- Another buyer in the market: The market does get excited that there is another buyer looking to accumulate the stock. This should provide some stock price stability and support.

The other proponents of buying back stock are the CEO and senior management. Not only does the announcement of a buy-back spark a share price jump, but most CEOs in Australia have short- and long-term incentives which are based on total shareholder return (TSR) and EPS. What's more, the average CEO in Australia has a tenure of less than five years. This does not give a heap of motivation to think about long term value creation or tail risks facing the company.

Therefore, they are heavily motivated to buy-back shares and less motivated to spend capital on innovation and growth where the returns are more long dated and harder to calculate. This is a tough position for a board to be in. They have pressure from some shareholders and most of the senior management team to buy- back shares. While this may be the right option, we feel that historically it has not always been the right option.

When buy-backs go wrong

1. National Australia Bank (ASX:NAB) buys back shares at $40.94 and raises two years later at $21.50

In November 2006, NAB announced at its FY06 results a $500 million buy-back because of its "strong capital position and commitment to active capital management". Then on 31 January 2007, NAB increased the buy-back by $700 million to make it a $1.2 billion buy-back. In the end of a period from November 2006 to May 2007, NAB bought back $1.2 billion worth of shares for an average price of $40.94/share. This was a price well above where the company announced the buy-back.

In the 2007 annual report which was released later in the year, the CEO and senior management team all received short-term incentives (which were based amongst other things on total shareholder return) which exceeded their target incentives. Then in July 2008, the CEO was replaced. In July 2009, the company raised $2 billion at $21.50/share. That is almost half the price the company bought back shares two years previously.

Now, this could be seen as being a little unfair in the context of the GFC. This caused a liquidity crunch in Australian banks which are reliant on offshore wholesale funding and all banks were forced to raise capital. However, this sequence of events highlighted a few things.

First, this quest for active capital management and a desire to return excess capital to shareholders tends to be calculated assuming current conditions prevail over the medium term. This is usually not the case and during the good times, banks should build excess capital to keep them in good stead during the bad times.

Second, it shows how incentivised the CEO was to maximise the short-term share price performance and the buy-back seemed to be a good way to achieve this goal.

2. Bluescope (ASX:BSL) buys back $707 million at $6.10 and raises $2.4 billion at $0.40 -> $3.10 three times in next five years

From the time Bluescope was spun off from BHP in July 2002 till June 2006, the company was generating good cashflow and was using its cashflow and balance sheet to buy back shares. In August 2006, the company's first page of the presentation took pride in the fact that it had bought back $707 million worth of shares (at an average price of $6.10) since listing and had paid $1.1 billion dividends. In FY06 the company had bought back $95 million worth of stock at an average price of $7.02. At the time of the results, the company also announced that the CEO would retire and be replaced in November 2007.

At the time this buy-back did not seem terribly controversial. However, when the company went on an acquisition spree in FY08 (Smorgan Distribution and IMSA Steel), it overstretched itself at peak margins.

Following these buybacks, dividends, ordinary dividends and acquisitions, steel spreads collapsed and Bluescope were forced to have three equity raises in three years.

- December 2008: Raised $413 million at $3.10
- May 2009: Raised $1.4 billion at $1.55
- November 2011: Raised $600 million at $0.40

Not only was this extremely dilutive for existing shareholders, but it meant that Bluescope couldn't take advantage of investing and acquiring at the low end of the cycle.

The main lessons from this is when you are running a highly cyclical company with massive operating leverage and a key revenue driver which is outside of your control, you probably don't want to have a pretty underleveraged balance sheet, especially at the top of the cycle. Buying back shares may seem logical

BSL share price

Source: IRESS

based on the earnings multiple and apparent strong cash generation, but we feel that this can be fraught with danger, as Blue Scope showed.

3. Lend Lease (ASX:LLC) buys-back @ $17.48 average, cancels buy-back @$12.85

In February 2018 Lend Lease announced a $500 million buy-back due to the strong cash position, solid profit growth and resilient balance sheet. The market cheered the announcement with one analyst commenting that it was the highlight of the result. "While only marginally accretive (c.4%), it signals confidence in the cash flows of the business."

The company was buying back all the way through to the Annual General Meeting (AGM) on 9 November 2018 when it had bought back $312 million of the $500 million at $18.40 average price. At the AGM, the company revealed a profit warning due to its underperforming engineering division, including taking a $350 million provision and conducting a comprehensive review. Given the company bought shares back the day before, this revelation must have come out of the blue. The stock fell 18% on the back of the profit warning.

The company then announced its interim result in February 2019 where it revealed operating cash outflow of $824 million and a $1.1 billion increase in net debt over a six-month period. The company also revealed that it would not be completing its buy-back. The shares closed that day at $13.28/share.

The big lesson for the Lend Lease board was to understand that they are a developer as well as an engineering company which constructs large fixed price contracts for clients (typically government clients). Cashflows in these sorts of businesses are extremely lumpy. If an engineering company gets the pricing or the conditions wrong on a fixed price contract, it can be catastrophic to cashflows. What tends to happen is that the client will stop paying once the contracted price has been paid. However, the construction company continues to have cash go out the door so as to complete the project to the client's specification. This means that the balance sheet at a point in time can deteriorate quickly.

Conclusion

When a company announces a buy-back, investors should not read too much into it as a signal for value. Boards have not traditionally been good judges of value or predictors of issues as has been demonstrated above.

However, not all buy-backs are bad. We believe that in the event of an asset sale it can be a good way of returning capital to shareholders. We also believe that if a cyclical company has managed to build up a strong balance sheet at the bottom of a cycle and there are no inorganic opportunities then a buy-back also makes a lot of sense. Sims Metal's (ASX:SGM) buy-back in 2015 is an example of this.

We believe that there is an optimal capital structure which maximises the sustainable return on equity (ROE) of a company without putting the company at risk or taking away balance sheet optionality in the future, but it is more art than science.

However, we believe that a medium to longer term time frame needs to be considered, although there will always be shareholders and CEOs pushing for short-term sugar hits. Having a good understanding of the cyclicality of a business, were we are in the cycle, disruptive threats, contingent liabilities, operating leverage, financial leverage and other tail risks is extremely important when making the decision.

We are seeing increased buybacks across Australia and globally. The benefits of each buyback can be judged on a case by case basis, but in aggregate it is a little concerning that as stock market is making new highs every day, the number and size of buybacks increases.

In a recent interview to the Economic Club of New York, Stanley Druckenmiller eloquently broke down the numbers. He made the point that corporate debt has increased from $6 trillion in 2010 to $10 trillion today. Despite this, earnings have only increased by $500 billion in aggregate. Unfortunately, this increase in debt is not going towards innovation or growth capex, but rather buybacks.

"Over the period 2010 to 2018, buybacks rose from 20% of capital expenditure to 55%, with a much higher stock market… I was afraid that people were going to do stupid things and indeed they have".

Anthony Aboud is Portfolio Manager at Perpetual Investments, a sponsor of Firstlinks. This article was written for educational purposes and is not meant as a substitute for tailored financial advice.
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How to spot genuine pricing power

Joe Magyer

Hypergrowth and crushed expectations are usually the investing themes that capture the most flattering financial press. A much less visible but even more powerful lever for the long-term investor, though, comes in the form of pricing power.

Businesses with a confluence of a strong brand, competitive position, and customer loyalty are often able to push through price increases alongside or even above inflation. Even if only applied with prudence, the ability to grow pricing at healthy rates speaks to the potential to surprise investors with higher-for-longer growth than short-term-minded investors might expect.

Start by inverting

One of the fastest routes to identifying businesses with pricing power is by inverting and screening out the price takers. For example, just about every commodity-centric business, from mining to farming, lacks pricing power because its products aren't materially differentiated, and most end buyers don't care about the sourcing. You probably care about who manufactured your shoes – branding matters in footwear – but probably never stopped to ask where the rubber in them was sourced from.

There are gradations when it comes to pricing power with commodities, of course, mostly having due to the concentration of supply and how long it takes new supply to come online. But a steel manufacturer looking to buy a certain grade of iron ore doesn't much care whether it was dug from the earth by, say, Rio Tinto or BHP Billiton, and the huge majority of commodity producers are price takers.

Retailers are another group that struggles to retain pricing power because barriers to entry are low and clever concepts are easily and quickly copied. The largest players can lean on suppliers for better terms, but even they struggle to flex pricing power with customers. They later resort to 'investing in price' in order to win back market share. Incidentally, shares of Woolworths today are no higher than they were six years ago.

Australia's big banks are not immune to market forces either despite the oligopolistic nature of the sector. It's a pain to change banks, thus they set their fees accordingly, but when it comes to setting rates it is largely set market forces that dictate their levels and the size of spreads.

Going positive on who has the power

So we just struck off financial, energy and materials businesses, which wipes away more than half the opportunity set by value of the ASX. Also, much of what was said above is applicable to companies in other sectors as well, all of which should give you a better feel for the rarity of true pricing power.

The first thing you should know when trying to spot pricing power is that most companies that have it don't advertise the fact -- even with investors -- because doing so might rub customers, suppliers, and regulators the wrong way. Large consumer companies aren't shy in discussing pricing – Procter & Gamble, for example – mostly because the prices themselves are public and the customer base is so diffused. Once you get past that low-hanging fruit it takes more thought and digging to spot pricing power.

The next best place to catch management discussing pricing strategy is to get on an analyst conference call. Almost every mid- and large-cap company, plus many small-caps, host a conference call after they release earnings results that investors of all stripes can listen to (details are usually found in the earnings release or announced prior). While a company might not be so brazen as to directly say how much increased prices contributed to their growth during the period, they often provide useful colour that can help investors get a sense of whether pricing power exists.

Beyond a company's out-and-out telling investors pricing power exists, investors can read between the lines of some financial measures. For example, if a business has high and stable gross margins, consistent revenue growth, and is showing no signs of losing market share, odds are decent the business has some degree of pricing power. Netflix would be a prime example. The price of its standard streaming plan in the US increased from US$9 in 2014 to US$13 in 2019, over which its gross margin expanded by around 5 percentage points to over 36% and total revenue more than tripled.

Take note that just because a business has a premium brand or higher gross margins than its peers does not mean the business has pricing power. A luxury automaker probably has higher gross margins than one more focused on value and volume, for example, but the luxury automaker also has a smaller revenue base over which it can leverage its fixed costs, plus automaking is an intensely cyclical and capital-hungry business. That is to say, even if a luxury automaker has relative pricing power, it doesn't mean they have absolute pricing power. In fact, in the US, prices for new vehicles basically haven't budged over the past two decades despite total inflation of around 50% over that time.

Another quantitative directional indicator is based on average revenue per customer. If it is increasing faster than inflation and without driving down customer-level churn, it means the company is effectively raising prices or leveraging an existing strong relationship to cross or up sell, or some mix of both. A good example that is close to home is Xero, where churn rates in the core ANZ region fell a touch year on year despite a 4.8% constant currency increase in average revenue per user.

When the price is wrong

Just because a business has pricing power does not automatically make its shares a buy, of course. Numerous factors go into that sort of analysis, and even within pricing power itself it is important to watch the key underlying trends. For example, if a company is able to broaden its supply base or its own market is concentrating behind fewer players, both those trends bode well for pricing power. Likewise, if a company has been flexing its pricing power too hard for too long it can open itself up to disruption by more efficient competitors who compete on price and value rather than brand and prestige.

All that said, we think pricing power is a valuable trait for a business to possess for the long-term investor.

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Four things advisers can do to manage conflicts

Simon Carrodus

Many financial advisers don't think they have a conflict of interest, but they might be wrong.

Thanks to the Royal Commission, everybody is talking about vertical integration and in-house conflicts. We explain what this means and highlight four things advisers can do to manage conflicts effectively.

I'm a financial adviser. Am I conflicted?

Probably. Vertically integrated structures are common in the wealth management industry and it's not just the big banks that use them.

Putting yourself in the position of a financial adviser:

- Do you recommend financial products (including managed accounts) that are issued or operated by your licensee or corporate group?
- Do you recommend financial products that will give you, your licensee or your corporate group some type of financial benefit?

If you answered yes to either of these questions, congratulations! You're conflicted.

So, is my business doomed?

No. Commissioner Hayne toyed with the idea of separating product and advice – known as 'structural separation' – but in the end he rejected the idea.

But don't celebrate just yet.

While Hayne decided that it *should* be possible for advisers and licensees to manage in-house conflicts effectively, he was damning of the poor consumer outcomes caused by in-house conflicts in recent years.

We expect ASIC to scrutinise vertically integrated structures and in-house product recommendations this year. So advisers and licensees need to be able to demonstrate that they understand the conflict and can manage it effectively.

How do I do that?

You have to place your client's interests above your own. In most cases, your client will have an existing product. So you should:

- Perform a comparative analysis of the pros, cons, fees, risks and benefits of their existing product vs your in-house product, and

- Explain why your in-house product is better for your client than their existing product. It's not enough to just tell the client you have a conflict.

In-house product recommendations will *generally* be inappropriate if:

- The benefits of the in-house product are lower, or

- The costs of the in-house product are higher.

The exception to this is if there is a clear justification for your recommendation. For example, if your in-house product addresses a specific client need or objective that the existing product doesn't.

If you can't easily explain why you're recommending your in-house product, don't do it.

Is that all?

No. You have to record all of this on the client file and explain it in the Statement of Advice. Most advisers don't do this adequately.

If your advice is not properly documented and explained, you are effectively guilty until proven innocent.

So, what should I do?

You can demonstrate that you are managing your in-house conflicts by doing these four things:

1. Properly research your client's existing product
2. Link each recommendation to your client's needs and objectives
3. Explain why your in-house product is better for your client than their existing product, and
4. Record all of these things on the client file.

What should I do next?

Review your advice procedures and conduct a gap analysis. If you have any questions or concerns, get in touch.

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Finding safety and returns in a low interest rate world

Kate Samranvedhya

In a world where US$17 trillion of bonds trade at negative yields, Australian government bond yields are still high relative to the rest of world. There are very few AAA-rated countries where government bond yields are higher than in Australia. Year-to-date, some of these bond markets have generated positive returns ranging from 3-12% (as at 16 August 2019), defying any notion that low bond yields imply low returns. Remarkably, the best performing AAA government bond market, Switzerland, is the one with the most negative yields.

The persistence of high debt, low inflation, and bond yields

What's more striking for Germany, Denmark and Switzerland is that currently the financial market is willing to lend to these AAA countries at negative yields for every single bond outstanding, including the longest German government bond that will mature in 2050 and had its debut on 21 August 2019, and the longest Swiss government bond that will mature in 2064. The bond market's rally this year goes from strength to strength as many investors look to move into highly-rated fixed income for higher levels of protection in time of higher economic uncertainty.

10 Year Bonds Yields of AAA-rated Countries

AAA-rated Countries (as of 16 August 2019)	Level of 10Y Bond Yield in local currency	Year-to-date Total Return in local currency
Singapore	1.7	3.2%
Canada	1.2	6.5%
Norway	1.0	3.5%
Australia	0.9	10.7%
Sweden	-0.4	5.0%
Finland	-0.4	7.0%
Netherlands	-0.6	8.5%
Denmark	-0.7	9.6%
Germany	-0.7	7.4%
Switzerland	-1.1	12.6%

Source: Bloomberg and Jamieson Coote Bonds (Total returns are calculated from S&P Singapore Government Bond Index Total Return, Bloomberg Barclays Treasury Total Return of Canada, Norway, Australia, Sweden, Finland, Netherlands, Denmark, Germany, and Swiss Bond Index Domestic Government Total Return). Past performance is not a reliable indicator of future performance.

Negative bond yields have been around for at least five years, ever since the European Central Bank and the Bank of Japan took their policy rates below zero. What drives bond yields even lower this year is that central banks signal their willingness to keep their policy rates low or lower for much longer.

In both Europe and Japan, the central banks believe that negative policy rates and quantitative easing diverted their economies from a deflationary trap, but headline inflation settles near their respective core inflation levels at around 1% in Europe, and 0.5% in Japan. Meanwhile, in Australia, the RBA has cut the official cash rate by 0.5% so far this year, after inflation dropped. In many developed nations, inflation is persistently lower than expectation.

Why is it so hard to generate inflation when central banks are already undertaking unconventional policy?

Inflation usually arises when growth overheats, which the world has not experienced in a long time. There are bigger forces at play outside central banking policy.

First, an aging population leads to lower potential economic growth. Japan and Europe are heading that way.

Second, in the past, accumulation of debt had enabled higher levels of consumption and growth. As debt burdens keep loading up over the years, it can generate less growth than in the past. Lower growth, no overheating, leads to low inflation.

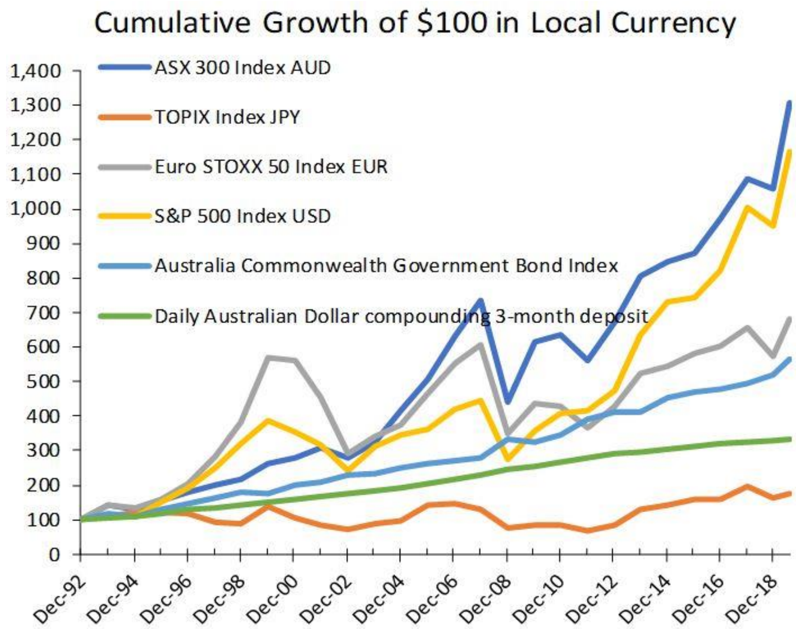
Third, a weak banking system needs time to heal, as in the case of Japan and of the European banks. Hence, central banks have been steering economies on a low, and lower interest rate path to enable a growth friendly level of indebtedness.

How should Australian investors approach this lower-rate world?

Australia is one lucky country. It has just finished a mining boom and never experienced a severe housing crash, so far. If an individual had invested $100 into the Australian equity market at the end of 1992, reinvested all dividends, and let the power of compounding work its magic, that investor would have done even better than similar investors in the S&P500 Index. However the journey hasn't been a smooth path, as the GFC destroyed 40% of the accumulated wealth over the previous 16 years. It took almost six years to rebuild the cumulative growth to surpass the pre-crisis level, as seen in the chart below.

Not all equity returns derived from offshore markets have performed as well as the S&P 500 Index (yellow line) and the ASX 300 Index (dark blue line). The Euro Stoxx 50 index (grey line) has built up accumulated gains to this level three times in the last 30 years, only to have been destroyed by a whopping 40-50% twice in the past. It took the Euro Stoxx 50 Index eight to 10 years to re-accumulate to the previous levels.

Japanese investors, after their bubble burst in 1989, still barely accrue substantial wealth from investing in their stock market. Australian savers in short-term bank deposits would have accumulated more wealth than an investor in the Japanese equity index, but not as much as if they had invested in Australian government bonds.



Source: Bloomberg and Jamieson Coote Bonds

Made your money in equities? Store some of it in bonds.

In Australia, we are also lucky to have one of the most liquid AAA-rated government bond markets in the world. An individual or SMSF that invested $100 in Australian Commonwealth Government bonds in 1992, reinvesting all coupon payments, and enabling the power of compounding to work its magic, would have grown its capital five to six times, with a smooth accumulation path (light blue line). This is important for pre-retirees and retirees who seek lower volatility from their investments with steady growth.

Investors have an attachment to the stock market, but how many would tolerate losing 40% of our wealth? There seems to be a large divide between growing wealth and preserving it, or the need for safety. Bonds can also experience some drawdowns, however unlike equity markets, the drawdowns tend not to be as large. As the chart above highlights, investing in Australian government bonds would have preserved your purchasing power, when adjusted for inflation.

Where to seek a less volatile foundation for your portfolio?

Every investor is constantly reminded about the importance of balancing risk and return, but the right level of risk comes down to individual risk tolerances and stages of life. An investor who is 65-years-old may prefer a greater defensive allocation to highly-liquid high-grade bonds over equities, compared to a 30-year-old who has many years to accumulate wealth and ride out the volatility in equity markets.

Let's hope history does not repeat itself as it did in 2008, as it took six to eight years to stay invested in order to build back that lost wealth.

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Six suspects in the murder of inflation

Nicholas Stotz

What happened to Harold Holt? How did we allow mullets to become fashionable? Who murdered inflation? These are some of Australia's greatest mysteries, and economists have felled many a tree in recent years expressing their bewilderment that inflation has vanished without a trace.

The whereabouts of inflation in Australia and other major economies has been a monetary mystery for more than a decade now. According to economic theory, low interest rates should increase consumption and borrowing, increasing demand and resulting in higher prices. According to economic theory, low unemployment should force employers to offer higher wages as a way of competing for scarce talent. So, who could be responsible for the murder of inflation?

We've enlisted the assistance of Hercule Poirot, Sherlock Holmes and Jacques Clouseau to narrow down a list of suspects:

Suspect 1 - Amazon Armageddon: Increased globalisation has resulted in many Australian businesses having to keep prices low to remain competitive. This is particularly relevant for Australian retailers, who are struggling to keep up with the likes of Amazon.

Suspect 2 – The Grocery Wars: The price war between Coles, Woolworths and Aldi has helped keep a lid on inflation. A PwC report found that Aldi's presence in the Australian market has resulted in Australian shoppers saving more than $2.5 billion per year.

Suspect 3 - Follow the Money: The RBA has been lowering interest rates since November 2011. Total credit in the economy has increased by $890 billion since then, with housing loans accounting for 70% of that new debt. Australians didn't respond to lower rates by taking out more personal and business loans and stimulating economic activity as the RBA may have hoped, choosing instead to borrow up to their eyeballs in housing loans. At least there was inflation in property prices!

Suspect 4 - Underemployment: The ABS considers someone employed if they work more than one hour a week, meaning that low unemployment figures may be misleading. Underemployment, which measures workers who are employed but want to work more hours, is historically high. It should be no wonder that wage growth is non-existent when there are more than a million Australians looking for more work.

Suspect 5 - Not just call centres: Cheap foreign labour is typically associated with the decline of Australian manufacturing jobs, however thousands of white-collar jobs in Australia have been lost to 'outsourcing' (corporate Australia loves a euphemism!). As profit margins get squeezed, Australian companies can save up to 70% on wages by shipping low-skill jobs overseas. This trend will only accelerate as the quality of foreign labour increases, with high-skill white collar jobs increasingly at risk.

Suspect 6 - Running out of luck: The Australian economy remains anaemic, as reflected by its woeful productivity growth figuresand per-capita recession. China is building 20 million square metres of new floor space each month – for reference, the total floor space of Sydney's CBD is 17 million square metres. If China decides to stop building a new Sydney CBD each month, the demand for our major commodities will plummet and our much-treasured streak of 27 years without a recession will almost certainly end.

Who do you think pulled the trigger? Did the suspects work in cahoots? Were there other accomplices? Despite having a rock-solid alibi, the RBA appears to have pinned the murder of inflation on interest rates being too high. Sherlock Holmes once warned that we should twist our theories to suit facts and not the other way around. Rather than relying on conventional economic wisdom to solve this mystery, we should ask ourselves a simple question – why would prices and wages be rising in the first place?

Lowering interest rates further does nothing to improve the Australian economy, which needs major reforms to improve the quality of its labour force and business conditions. Although it is undoubtedly a foreign concept to them, our dear leaders in Canberra may actually need to stop sharpening their knifes and do some work. At this stage, we may as well save on the labour costs and outsource our politicians to the Philippines!

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What do negative rates and other RBA moves mean for investors?

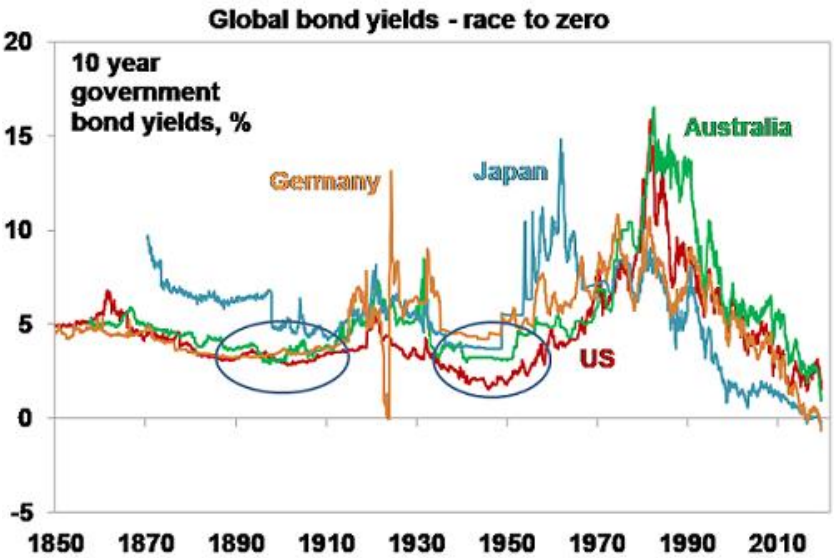
Shane Oliver

Since the RBA started cutting interest rates again in June 2019, there has been increasing debate that it will deploy so-called 'unconventional monetary policy measures' such as negative interest rates and quantitative easing (QE). This debate has hotted up in recent weeks after the escalation in the US-China trade war posing a rising threat to global growth, numerous central banks cutting interest rates this month in a so-called 'race to zero', the Governor of Reserve Bank of New Zealand saying that negative rates are possible and RBA Governor Lowe saying that its "prepared to do unconventional things if the circumstances warranted it" even though he also said that QE was "unlikely".

But what exactly are these unconventional monetary policy measures? Do they work? Would they work in Australia? Are there better options? Will they be deployed and when? What will it all mean for investors?

What's behind talk of unconventional monetary policy?

Put simply Australian economic growth has slowed sharply below its long-term potential reflecting the housing downturn and weak consumer spending. While house prices may be bouncing back in Sydney and Melbourne and there are anecdotes that the tax cuts are helping retailers, the downturn in housing construction has further to go and other factors from drought to the threat from the US trade wars cloud the outlook with increasing talk of recession globally. Slower growth has seen the outlook for unemployment deteriorate – at a time when there is still a high level of unemployed and underemployed (at 13.6% of the workforce). Which in turn threatens to keep wages growth and inflation lower for longer. So, with the cash rate approaching zero the question naturally arises of what to do next? Of course, Australia is not alone. There is an excess of global savings and this is driving ultra-low interest rates.



Source: Global Financial Data, AMP Capital

What are unconventional monetary policy measures?

They refer to a bunch of policies which have been deployed by major central banks in the aftermath of the GFC. They are:

- explicit forward guidance – where the central bank indicates the cash rate is not expected to rise for some time period
- very low and negative policy interest rates
- QE which has involved using printed money to purchase public and private securities
- providing cheap funding to banks to support lending, and
- intervening to push the Australian dollar lower.

But do they work?

A common comment is that "QE etc hasn't worked in the major economies so why should it work here?". In reality such policies do appear to have helped notably in the US and Europe where they were progressively deployed from the time of the GFC once interest rates hit zero and then became the lone stimulus measures as fiscal austerity took hold.

Since its high in 2013 unemployment in the Eurozone has fallen from 12% to 7.5% and in the US it fell from 9% in 2011 to 4% in 2017 enabling the Fed to start unwinding unconventional monetary policy. Inflation has not been returned to 2% targets, but wages growth has lifted and at the start of last year it looked like the global economy was getting back to normal. So unconventional measures have helped. Of course, Trump's trade wars have provided a big threat since then.

The main lessons look to have been that different measures are appropriate depending on the issues facing a country, that a range of measures are preferable to just one and that central banks need to go early unlike Japan which left it too late.

Will it work in Australia?

Our assessment is that unconventional monetary policy measures may help in Australia, but it will depend on the measure deployed and their impact will be limited particularly compared to overseas.

Explicit forward guidance – the RBA has already started this with its comment this month that "it is reasonable to expect that an extended period of low interest rates will be required". If the US and ECB are any guide this is likely to morph into a specific time period through which rates will remain low. This can help keep bond yields low, but the low yields in other countries dragging our yields down will arguably do this anyway.

Zero or negative interest rates – while the Fed stopped cutting rates in the GFC and its aftermath at 0-0.25% and the Bank of England stopped at 0.25%, the Bank of Japan and several European banks led by the ECB have taken rates negative. This negative rate applied to the deposit rate banks get for leaving deposits at the central bank and was motivated to encourage them to lend out cash which was building up as reserves due to quantitative easing. There is some evidence that negative rates in Europe have boosted bank lending but cut into bank profits because banks are reluctant to take interest rates on bank deposits (which are used to fund lending) below zero and so further falls in lending rates lead to reduced profit margins which may crimp lending. The thought of negative rates may also scare people. Sure a 10% bank deposit rate and 12% inflation is really no different to a -1% deposit rate and 1% inflation – but the former would feel a lot better!

For these reasons it would make sense for the RBA to call a halt to cash rate cuts around 0.5% (which we expect to see by year end) or maybe 0.25%. There would be little point in going to zero or negative as the banks will be unlikely to pass it on in lower mortgage rates as they won't want to take deposit rates negative. So negative interest rates will hopefully be avoided.

Asset purchases under quantitative easing – QE in the US, Europe and Japan involved pumping printed money into the economy by central banks buying government bonds, high-rated private debt and, in Japan's case, some shares. This was aimed at pushing long-term bond yields and hence borrowing costs even lower, boosting narrow money in the economy with the hope that it will be lent out, pushing investors into more risky assets to make more capital available for investing and (although they don't admit it) pushing their currencies down. It tends to be what you do once interest rates have hit zero.

In Australia, QE may provide less help because there are less Government bonds for the RBA to buy given relatively low public debt in Australia, bond yields are already low anyway and in any case 85% of mortgage borrowing is linked to short-term interest rates and so there would be little benefit to the household sector from lower long-term bond yields.

There is no guarantee that the cash pumped into the economy is lent out and spent and a lot of it has just helped share markets (which is good for the better off) at a time when interest rates are low (which is not so good for lower income earners who rely more on bank deposits).

Cheap funding for banks – the RBA did this around the time of the GFC and the ECB and the Bank of England have provided cheap financing to banks tied to them boosting lending. It's not really an issue at present in Australia as banks are not facing difficulties in terms of funding and the recent slowdown in credit growth in Australia owes more to tighter regulatory oversight around "responsible lending". However, following the UK experience the provision of cheap funding to banks may be a way for the RBA to ensure that cash rate cuts are continued to be passed on to lower mortgage rates and that lending holds up as the cash rate gets closer to zero.

FX intervention – this is a return to old fashioned RBA intervention in the foreign exchange market to push the $A down by selling Australian dollars and adding to its foreign exchange reserves with the aim of helping growth. It seems unlikely though as it would be criticised by other countries as competitive devaluation and the $A is already low anyway.

Will the RBA deploy unconventional policies?

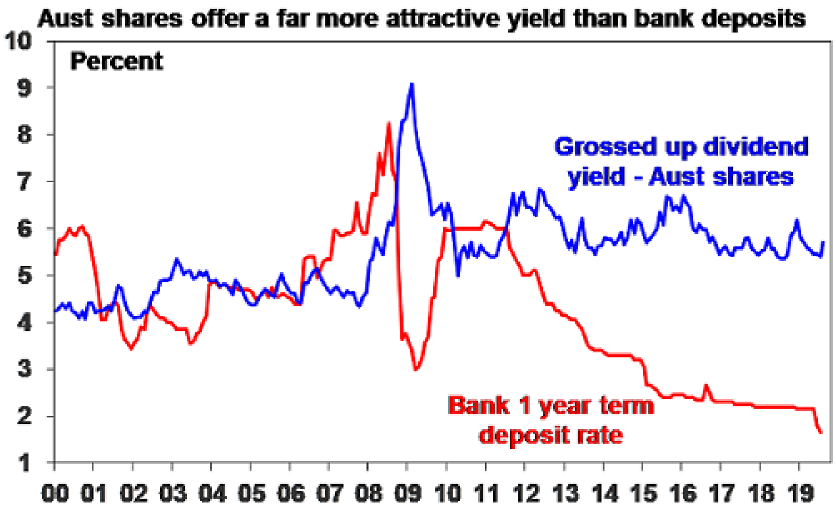
The RBA is likely to exhaust conventional easing by cutting the cash rate to 0.25-0.5% before doing unconventional measures beyond forward guidance. The probability of other measures next year is rising. Negative interest rates are unlikely but quantitative easing would likely be included. Ideally this would involve working with the Government to provide a fiscal boost.

Implications for investors?

There are a number of implications for investors.

First, bank deposit rates are likely to fall even further and remain unattractive for a lengthy period yet.

Second, the low interest rate environment means the chase for yield is likely to continue supporting commercial property, infrastructure and shares offering sustainable high dividends. The grossed-up yield on shares remains far superior to the yield on bank deposits. Investors need to consider what is most important – getting a decent income flow from their investment or absolute stability in the capital value of that investment.



Source: RBA, Bloomberg, AMP Capital

Third, the continuing low interest rate environment will support Australian residential property prices, but still high debt levels, tight lending conditions and rising unemployment mean that it's unlikely to set off another full-blown property boom.

Finally, easy monetary policy in Australia will likely help keep the $A lower than it otherwise would be.

Dr Shane Oliver is Head of Investment Strategy and Chief Economist at AMP Capital, a sponsor of Cuffelinks. This article is general information and does not consider the circumstances of any investor.

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