Edition 365, 10 July 2020

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Editorial

The stock market and its many participants deserve admiration for hanging on to recent gains in the face of complete uncertainty. The S&P/ASX200 is only about 11% below its level at the start of 2020, and economic conditions and the outlook are clearly far worse. The **Reserve Bank** wrote this week:

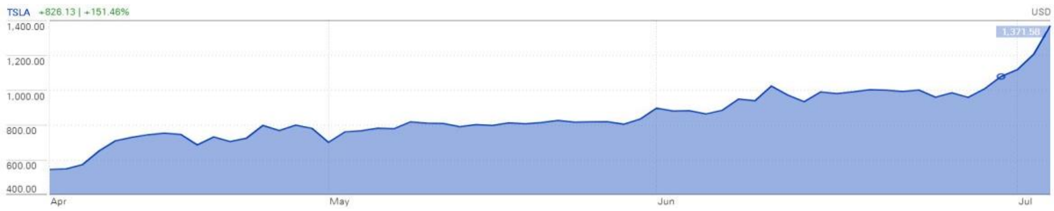
"Uncertainty about the health situation and the future strength of the economy is making many households and businesses cautious, and this is affecting consumption and investment plans. The pandemic is also prompting many firms to reconsider their business models."

Then **Gareth Aird** of CBA's Global Markets Research acknowledged economists themselves are struggling. Anyone who thought Australia had flattened the curve and was heading for a V-shaped recovery has been jolted by events in Victoria. He wrote:

"Economists are having a torrid time trying to forecast the economic outlook as a whole host of unusual dynamics play out. Many traditional economic models are of little use right now as policymakers globally continue to grapple with the trade-off between limiting the spread of COVID-19 and the negative impact on the economy from restrictions on what people can and can't do."

Amid the uncertainty, some stocks are enjoying the best rally of their listed lives. It's easy to forget that a $70 stock like **Afterpay** listed only a few years ago at $1, closing the first day at $1.25. We lead this week with a look at [Afterpay's success and investment lessons]() from a stock that ignores normal valuation techniques.

Similarly in the US, **Tesla** is on a tear after posting a first quarter profit for the first time. **Elon Musk** is laughing at the shorters. The market does not even care that its main plant in California was closed for a few months, as Morningstar Strategist **David Whiston** reports: *"If a recession can't stop Tesla then virtually nothing will, and we expect the company to remain a leader in autonomous technology and range. Tesla is also gaining scale and its ability to make desirable vehicles while generating free cash flow and net profit is far better than it's ever been."*



This week, **Ashley Owen** reviews the Australian stock markets in FY20 by major sectors, placing the numbers in recent context and checking how much returns have relied on dividends in the past.

Then **Hugh Dive** looks ahead to the most uncertain August reporting season for a decade, as well as compiling this chart of the market dogs of last year.

Dogs of the ASX in 2020

Company	Industry	Return in FY 2020	Reason for Large fall
Flight Centre Travel	Travel	-68%	Travel
Oil Search Ltd	Energy	-52%	Falling Oil Price
Virgin Money Uk PLC	Financials Services	-52%	Brexit/UK Economy hit hard by CV-19
Cimic Group Ltd	Construction	-45%	Surprise exit costs from Middle East JV
Incitec Pivot	Chemicals	-44%	Falling ammonia price
Vicinity Centres	Listed Property	-38%	Closure of retail stores
Worley Limited	Engineering Services	-38%	Falling Oil Price
Scentre Grp	Listed Property	-38%	Closure of retail stores
NIB Holdings Limited	Health Insurance	-37%	Higher claims expense in first half
Woodside Petroleum	Energy	-37%	Falling Oil Price

Source: iress & Atlas FM

The value versus growth debate is ongoing, and **Stephen Bruce** checks the conditions necessary to give value a better run, and whether the pandemic leans into this change. Then **Angus McLeod** looks ahead to five industries facing the profound and perhaps permanent impact of COVID-19, especially as we now know it will not go away until there is global availability of a vaccine.

Michael Recce identifies six types of 'big data' we need to watch, emphasising that the ability to interpret the numbers and integrate them into an investment process is vital to adding performance.

Jonathan Rochford called it 'madness' when investors trusted **Argentina** with a 100-year bond in 2017 but they have done it again with **Austria**. This time, it might not be credit risk but the price loss from small rises in rates is extraordinary over such long terms.

Finally, two articles on growing market segments. **Richard Montgomery** shows why not all ethical ETFs are the same, while **David Zipparo** and **Tim Davis** explain what to look for in private debt as it faces special challenges and opportunities this year.

In this week's White Paper, AMP Capital's **Shane Oliver** gives his review of FY20 and his views on FY21 amid the turmoil.

Now that's a packed edition worth reading over a slow cup of coffee.

11 lessons from my lousy $50K profit on Afterpay

Graham Hand

On 23 March 2020, Afterpay (APT) traded at a low for the year of $8.01 and 18.8 million shares changed hands. On 3 July 2020, Afterpay hit $70, a rise of almost 800% in only three and a half months. That's a lot of winners and losers in a short time. When the history of the amazing investing year of 2020 is written, Afterpay will be the feature stock. Co-founders Nick Molnar and Anthony Eisen both own 20.5 million shares or about 8.1% of the company, worth nearly $1.5 billion each at $70. The 30-year-old Molnar is currently Australia's youngest self-made billionaire, pipping the 32-year-old Melanie Perkins, the co-founder of graphic design platform Canva. With a market capitalisation around $18 billion, Afterpay is an ASX Top 20 company.

Afterpay share price, 1 January to 5 July 2020

Source: Morningstar Direct

Afterpay was founded in 2014 and listed on 4 May 2016 at $1, ending its first day at $1.25. It had received $8 million in private investment prior to the float, including backing from Ron Brierley's Guinness Peat group, where Eisen had been Chief Investment Officer. Don't kick yourself for not buying in the float. In the first half of 2016, Afterpay had revenues of only $220,000 and underlying merchant sales were about $3 million a month with 60,000 customers. It now has almost 10 million customers and adds them at 10,000 to 20,000 a day.

The business model, called Buy Now Pay Later or BNPL, is simple. Someone can own a $200 pair of sneakers immediately by paying four fortnightly instalments of $50 with no interest or fees if they pay on time. Merchants are charged a transaction fee as a percentage plus a flat fee, but most promote the product because it increases sales and Afterpay takes the credit risk.

My investment experience and valuing Afterpay

Afterpay has taken thousands of retail investors on a ride few will experience again, leaving behind the most astute professional investors in the country. Relatively few fund managers believe in the value. On 23 June 2020, Morningstar published an article called "Buy now, regret later? How Afterpay is dividing punters and pundits" showing most fund managers are underweight.

A few weeks ago, I mentioned to a colleague that Firstlinks was publishing an article on the estimated value of Afterpay, and he said, "*Don't tell me, I hate that company.*" Imagine the mood of the people who sold at $8.01 a few months ago.

How do I feel having dabbled a mere $10,000 in Afterpay in December 2017, selling most of my shares along the way, and turning it (at the moment) into a 'profit' of $50,000 when it could have been $130,000 if I had held on?

Here are my Afterpay transactions. You might think a profit of $50,000 is nothing to sneeze at, but it feels like a shallow win.

Date	Buy	Sell	Price	Value*	Balance	Profit (FIFO)
5/12/2017	1,000	-	$5.27	$5,289.95	1,000	$-
6/12/2017	1,000	-	$4.98	$4,999.95	2,000	$-
3/09/2018	-	500	$18.47	$9,214.17	1,500	$6,569.20
25/02/2019	-	500	$18.09	$9,025.05	1,000	$6,380.08
3/02/2020	85**	-	$23.00	$1,955.00	1,085	$-
25/03/2020	-	500	$14.87	$7,415.00	585	$4,915.03
26/05/2020	-	200	$49.45	$9,870.05	385	$8,870.06
Still held			*$70.00*	*$26,950.00*	*385*	*$23,495.02*
TOTAL						**$50,229.37**

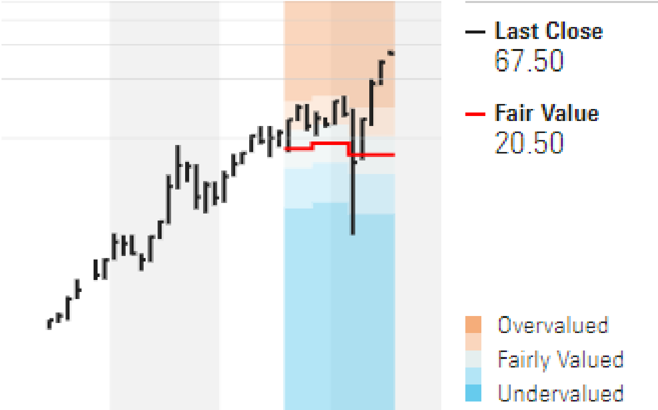
** includes brokerage*
*** Share Purchase Plan, applied for $15,000, refunded $13,045. Typical!*

So two guys half my age make $3 billion and are in the process of selling 10% of their holdings for $135 million each, and thousands of other people have made small fortunes, while I make a lousy $50,000 on a 70-bagger stock (floated at $1, now $70). I realise $50,000 is better than a poke in the eye but it's not much of a result for investing in the biggest stock market success of the decade.

I'm not a stock trader. I'm a 'buy-and-hold' sort of chap. I prefer the Warren Buffett guidance to '*only buy something that you'd be perfectly happy to hold if the market shut down for 10 years*'. So the dalliance with Afterpay in the past couple of years is not my usual style. Normally, I couldn't be bothered trading smallish amounts, but Afterpay is no normal stock.

It's not possible to value this company on normal metrics. Investors must believe the growth story. Morningstar analysts estimate a fair value of $24.10, with an uncertainty rating of 'very high'. Citi recently upgraded its target from $27.10 to $64.25. UBS gave it a value of $17 last year then downgraded it to $13 with a 'sell' recommendation and more recently to $27. The bulls are Morgans at $68.58, Macquarie at $70, Bell Potter at $81.25 and as we go to press, Morgan Stanley at $101. Like, who knows? The chart below shows the rise since Morningstar initiated coverage with Afterpay heading into overvalued territory.

Morningstar Price versus Fair Value Chart for APT, as at 5 July 2020



2017	2018	2019	YTD	
—	—	1.25	3.29	Price/Fair Value
—	107.71	136.13	130.53	Total Return %
—	110.45	112.73	122.41	+/- Index

Social media is alive with frustrated investors who cannot accept what has happened, and an equal number of true believers.

> **ASX Trader** @JV19804 · Jul 3
> An unprofitable business built on people that cant afford to buy a t-shirt upfront. $18bn market cap, utterly ridiculous no matter how you value it. Be interesting to see how it copes once people have to actually pay their mortgages & rents again **$apt** #asx #equities

What are the lessons from this experience?

I'm not a stock analyst but here are some lessons to ponder:

1. Watch your anchoring biases

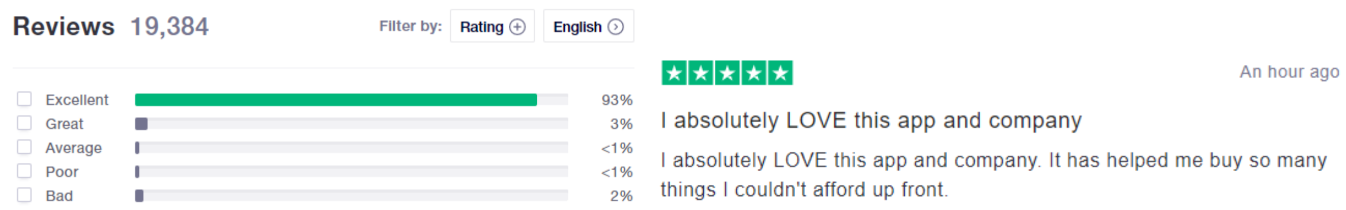
'Anchoring' is a major tenet of behavioural finance whereby an investor places too much emphasis on some prior information or number. I remember thinking when I first sold 500 shares that it would pay for the initial 2,000 shares, covering me for whatever happened in future. The $14.87 sale in March 2020 was influenced by the $8 price a few days earlier, and the $49.45 sale was based on a notion of a $50 ceiling. Even professional investors have arbitrary rules for selling but a stock like Afterpay brings out behavioural biases when there's not much else to cling to.

2. Discover an information edge

When a stock trades between $8 and $70 in a few months, it shows the market is far from an efficient pricing machine. However, there are times when you might discover something about a company that may not be fully factored into the price, or at least give you more confidence. During my Christmas shopping in December 2017, I was amazed how many stores had an Afterpay sign next to the cash register. 'Afterpay it' seemed more common than Amex or Visa. Some stores, such as Rebel Sports, included an Afterpay promotion on every display unit throughout the shop. I asked a friend who was a senior executive in a top-end sneaker business whether Afterpay was popular, and he said about one-third of buyers used Afterpay. One third! I'm not saying the market was unaware of Afterpay's rapid growth by December 2017, but did it fully allow for younger generations embracing the BNPL idea?

3. Look for companies that customers love

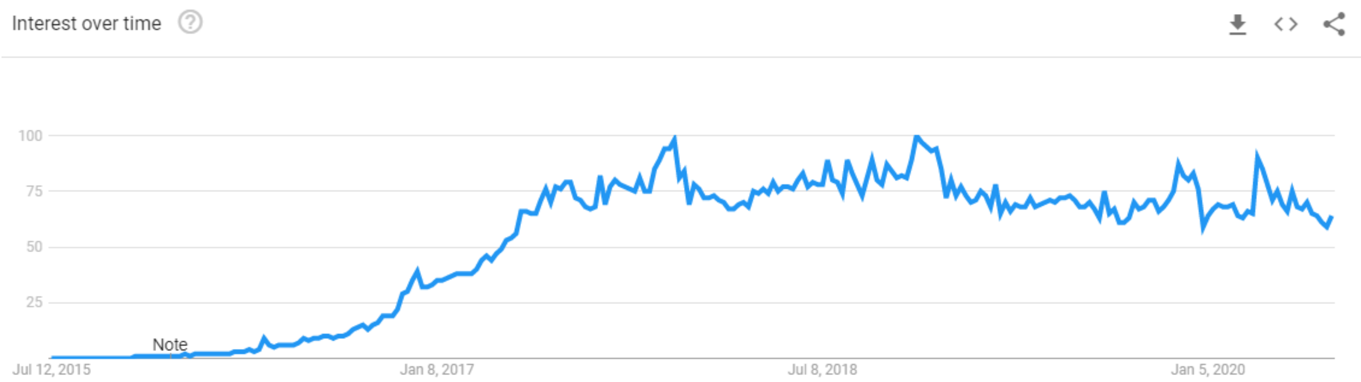
Successful investors look for unique data sources, and scouring the internet for customer feedback is a good measure of repeat business potential. One such source is Trustpilot, and here is a summary of their Afterpay user reviews plus a typical comment (putting aside the merit of people buying things they cannot afford).



4. Check what is happening on Google Trends

Another non-traditional data point is Google Trends. This is available to anyone, and its use should not be confined to professionals doing thorough research.

Here are the results over the past five years for the word 'Afterpay'. It has been surprisingly steady for a couple of years but a close watch would have revealed it coming to prominence over 2017.



5. Find companies that other businesses promote

This is a variation on a 'network effect', where the more people who use a product, the more valuable a business becomes. As Afterpay adds users, more retailers are compelled to join as customers are attracted to the payment method. Over the last year, merchant numbers have increased from 32,300 to 55,400.

Thousands of retailers not only allow Afterpay, but openly sing its praises, which leads to new customers, and more praise, and on it goes. Consider this from a US retailer, Outerknown:

"Afterpay is a service that allows us to offer our customers the ability to make purchases now and pay for them in four equal installments, made every 2 weeks, without any interest.

Just shop Outerknown.com and checkout as usual. At checkout, choose Afterpay as your payment method. You will be directed to the Afterpay website to register and provide payment details (Visa or Mastercard). If you've used Afterpay before, just log into your Afterpay account. Then complete your order -- it's that easy."

Wow. "It's that easy". Free promotions like this are better than paid advertisements.

6. Check when a company is embedded in another's process

Afterpay is now embedded into the payment processes of thousands of businesses, in the same way it took Visa and Amex decades to achieve. The move to more buying online is another positive. The Afterpay purchase process is tempting to users about to pay for $200 when on the payment page, they are asked if they would rather pay $50 now and $50 a fortnight, at no added cost.

Similarly, when a company embeds an IT system or platform into its own processes, it is often a major exercise to unravel and change to another supplier. Inertia and routine are powerful ways to retain business.

7. 'You never go broke taking a profit' is poor advice

Most listed companies are not successful over time, either disappearing or underperforming the index. Ashley Owens' article, '99% of listed companies disappear worthless' is a stark reminder that investors need strong winners to make up for inevitable failures. A better saying might be 'Let your winners run', although there are many examples of companies which have won in the short term and crashed over time. For example, a former market darling, Axsesstoday (AXL) rose strongly in 2018 from $1.50 to $2.50 then quickly went into voluntary administration, leaving the shares worthless and paying bondholders less than 30 cents in the dollar.

These trading rules are dragged out when they work and ignored when they don't, but simply 'taking a profit' is not a reason to sell a good investment.

8. You don't need to like the product to invest in the company

I will never use Afterpay and most of my Baby Boomer generation will ignore it, but we're not the target market, so nobody cares. It's not simply that my financial circumstances do not require me to pay for items in instalments. At no time in my life if I could not afford $200 sneakers would it make a difference to pay them off over four lots of $50.

I am not keen that a product like BNPL facilitates young people buying things they cannot afford. The Afterpay slogan, 'Shop Now. Enjoy Now. Pay Later.' encourages buying using debt. Customers are experiencing near-term gratification when they should live within their means in the same way they should not take on credit card debt. At least the Afterpay debt is required to be paid off quickly, whereas credit card debt is often permanent.

9. Retail Share Purchase Plans are inequitable

The February 2020 Share Purchase Plan allocation of 85 shares costing $1,955 was the most given to any retail investor who applied for $15,000 worth. The retail raising was originally capped at $30 million although they accepted $33 million. At the time of the announcement of the plan, Afterpay advised it "was intended to follow shortly after the successful placement of shares to institutional and professional investors (Placement Shares) which raised $317.2 million (Placement)." That's ten times as much for professionals as retail.

10. You don't need to value a company to invest in it

What's Afterpay worth? Could be $10, could be $100. Here is Morningstar's opinion. Arguments about the value of companies fly around fund manager offices every day, but normally, an analyst will produce a detailed spreadsheet with future revenues and costs and a discounted cash flow calculation. Amazon was considered a crazy Jeff Bezos business model for 20 years. Tesla cars rate poorly for quality control but the company is now the most valuable car maker in the world. Valuing is more art than science.

Sometimes, an investor must back their personal judgement, buy into the dream and the growth story and overlook the near-term losses. Venture capitalists and private equity are built on this idea because businesses like Tesla, Canva and Afterpay are not valued on Price to Earnings ratios. Of course, we conveniently overlook that there are far more start-up failures than successes when we swoon over these winning companies.

Gavin Purcell @ASXwatcher007 · Jul 3
Hi All, by my calculations AfterPay $APT is trading on a Revenue Multiple of 41 times and Xero $XRO 18 times. These are very high multiples and it's like the year 2000 all over again! Be Careful! 😊🇦🇺 #TechStockBoom #BeCareful

11. A simple, replicable business is not necessarily a bad business

To the outsider, it seems easy for the PayPals, Mastercards and Visas of the world to introduce a similar model. It's just a variation on the old lay-by, so why don't major retailers replicate it? Afterpay doesn't appear to have much of a 'moat' beyond its brand and market penetration, something which many professional buyers look for to protect a quality company.

But when anybody says, "I'll Google it" or "Get me a rum and Coke" or "Let's Zoom" or "Whatsapp me" or "We'll Afterpay it', you know a business has gone beyond a brand.

Where to from here?

I don't know what Afterpay is worth. Half my 'profit' is on paper and it could disappear or double. I could be writing an article in a year about why analysts' low valuations should have been heeded.

Of course, there are risks. When a stock is priced for perfection, it's easier for the halo to slip. The looming economic cliff may lead to a significant increase in unemployment and compromise Afterpay's strong credit record. Somehow, they have kept bad debts below 1% without thorough credit checks.

At some point, there will be a rotation out of growth stocks into value, and we may look back on tech valuations and shake our heads. But this is not like the tech-wreck of 2000. Tech companies such as Microsoft, Alphabet, Facebook and Apple are quality companies with serious earnings. Clearly, Afterpay is not in their league, but as a Top 20 company in Australia, it's hard to ignore.

Anyone buying Afterpay at $70 is in for a wild ride, but to date, those who sold after a fall have missed the next run. Those buying into a growth story like this should mentally prepare to hang in for the long haul. For a little diversity, the BNPL theme can be backed in other names such as Sezzle, Zip and Splitit, but they are all part of the same bubble. Splitit listed in January 2019 at 20 cents and traded this week at $1.48.

I'm not even sure what to do with my paltry 385 shares. At least they give me the right to participate in the new Share Purchase Plan announced this week, priced at $66. Any fundamental number crunching is little help at this level. You either believe the growth story, or you don't.

Graham Hand is Managing Editor of Firstlinks. This article is general information and does not consider the circumstances of any investor. An investment in Afterpay carries a high risk of loss and this article is not a recommendation to buy or sell. Every investor should do their own additional research.

How did shares perform in FY20 and where to from here?

Ashley Owen

At the end of another financial year, this article reviews performance of major investment asset classes over the past few cycles.

The 2019-20 financial year was poor across the board for diversified investors as each of the major asset classes posted lower than historical average returns. 'Risk' assets like shares and property were hit by the sharp coronavirus sell-off in February-March 2020, from which most shares and bonds have not yet fully recovered. In the case of 'defensive' assets like cash, term deposits and bonds, the low returns for the year were due to ultra-low interest rates in Australia and across the world.

Poor year follows a good run

Bad years happen from time to time, but we need to look at this in context. The calendar years 2012 to 2017 constituted an extraordinary run of six consecutive years of above average real returns from all of the main asset classes - something that had never happened before in history. We said at the time that this could not continue. Calendar 2018 was a negative year thanks to the 'global growth scare' in the December quarter, but markets rebounded strongly in 2019 to over-priced levels once again. Something had to give, but what we didn't know was the trigger, until the coronavirus shut-downs.

The chart below shows total returns (price gains plus reinvested income) for each financial year since 1999-2000 for the broader Australian share market (top chart) as well as the main segments popular with investors – banks, resources, and small companies. The bar to the far right shows the average compound annual total return over the past 20 years.

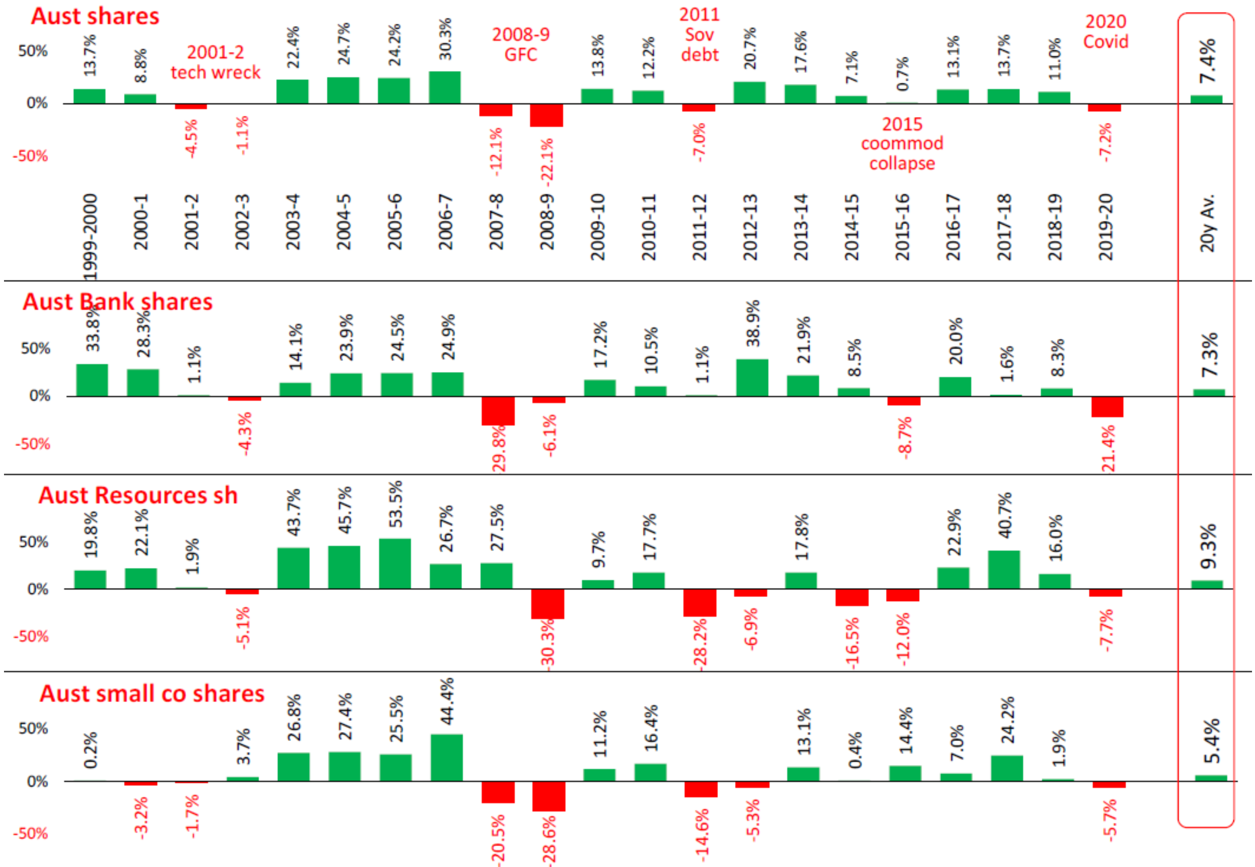
On the whole, Australian shares posted their worst financial year return since the GFC, just pipping 2011-2012.

The biggest drag on the market for the latest year was the banks (second chart above). Three of the big four banks were down by one third, with CBA down 16%. Macquarie lost 5%.

The big miners also lagged the broad market but by less than the banks. Fortescue was the star (up +53%) thanks to the surging iron ore price after the mine disasters in Brazil. BHP was down 13% and RIO down 6% on collapsing prices of coal, oil and most industrial metals in the global slowdown. The right bar on the Resources chart shows how they have beaten the banks and also the broad market over 20 years by a margin of +2% per year.

Small companies are speculators' perennial favourites but they are also perennial disappointments on the whole. This year some small stocks did well, riding the global shift to e-commerce and on online services, which has been accelerated by the coronavirus shutdowns.

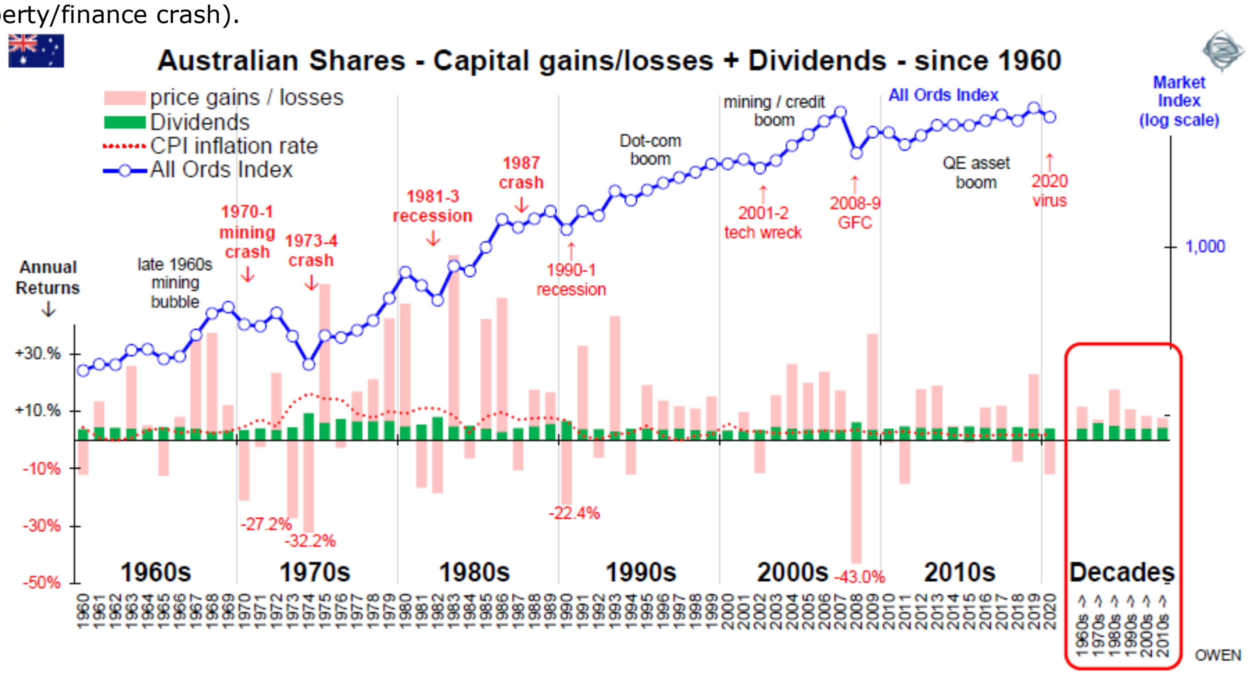
The last 12 months has seen a rather mild share market compared to the past two major recession sell-offs – the 2001-2002 'tech wreck' and the 2008-2009 'GFC'. Those were very mild economic contractions compared to the current much deeper coronavirus contraction but share prices on both occasions suffered much deeper and longer set-backs than we have seen in the current coronavirus crisis thus far.



Part of the difference is the monetary and fiscal support measures have been much larger and more extensive this time around, but even these extraordinary stimulus measures will probably not be enough to prevent company profits and dividends being cut by as much as they were in the tech wreck and the GFC.

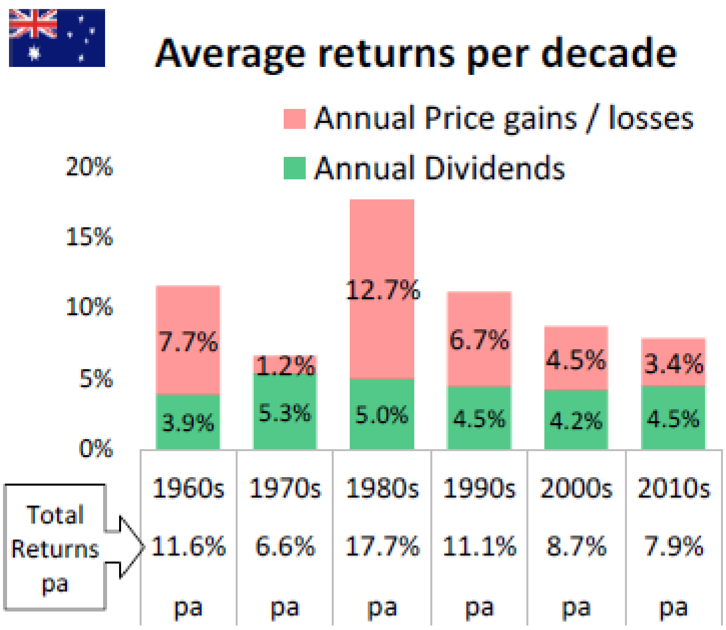
Dividends from Australian shares

The next chart shows returns from the broad Australian share market over the past 60 years, highlighting the sources of total return each calendar year. 'Total returns' are a combination of price gains or losses, plus dividend income. The green bars in the lower section show the dividend yield each year and the pink bars show the change in the share price index each year. The price movements (pink bars) are very volatile from year to year. For example, see the -43% price drop in 2008 (GFC) and -32% in 1974 (credit squeeze and property/finance crash).



While the wild share price index moves make great media headlines, and they are important for short-term traders and speculators, they are not important for diversified investors unless they have to sell.

For long-term investors, dividends pay the bills, not share price gyrations. The green bars show that the returns from dividend yields from the broad share market have been relatively consistent over time despite inflation (red dotted line) swinging wildly – up to 17% in 1975 and down to 0% and even briefly negative in 1962 and 1997.



The average returns per decade are highlighted at the right of the above chart, and these are expanded in the chart to the left.

Dividend yields were slightly higher in the 1970s, and that was also when inflation was highest. Yields were higher mainly because share prices were lower (inflation hurts share prices much more than it does dividends). Share prices then recovered strongly in the 1980s but dividend yields remained relatively constant, meaning the dollar amounts of dividends grew along with share prices.

Dividends do vary from year to year of course – companies increase dividends during booms but reduce them in slowdowns and recessions to preserve capital. Aggregate dividends across the Australian market have fallen by around 8% over the past year (mainly from the banks for reasons unrelated to the coronavirus shutdowns) and they are likely to fall by at least that much again as the shutdowns hit profits, but it will probably still leave returns from dividends near 4% over the coming year.

The above charts do not include the benefits of 'franking' credits for Australian owners of Australian shares. Franking credits (off-settable against other tax payable) were introduced from July 1987, and then refunds on franking credits were introduced from July 2000. This has added an average of +1.7% to yields since 1987 (it was +1.9% in 2019), bringing 'grossed-up' yields to above 6% for Australian residents.

The three big factors lying ahead

There are now three factors in play.

First is the coronavirus itself. The crisis has reminded us that some countries (like the US and Australia) are essentially just loose federations of States which can and do make their own rules and set their own path. This cycle of waves of infections and restrictions may continue until a cure or vaccine is found – perhaps next year. The US is the largest investment market and the most important for global investors, and infection rates there have now re-spiked up to twice the level of the first wave in April.

Second is government spending and borrowing. Formerly capitalist governments everywhere have now turned into welfare states in which they have become lenders, spenders, employers, and owners of last resort to try to directly or indirectly 'save' jobs and votes.

Investors will need to keep a close eye on how much governments can borrow before something pricks the confidence bubble. In Australia the Commonwealth was carrying a low debt level of around $50 billion before the GFC. Then to counter the GFC it borrowed an average of $50 billion per year net for next 10 years, taking the level of debt to $560 billion before the virus hit. Since the virus shutdowns, it is now borrowing around $35 billion per month to fund all of the welfare programs.

Third is central banks. Since the GFC, they have become buyers of last resort of government bonds, mortgage bonds, corporate bonds and even shares and property trusts (in the case of Japan). Our own RBA has spent $51 billion buying up government bonds since the March crisis. They say it's tiny, but it is the same amount as the entire stock of government debt before the GFC.

Meanwhile, in the coming months we will be keeping an eye on the virus numbers, as well as the unemployment numbers and loan arrears rates, and how governments react to them. The big question in the short term in Australia will be whether the government can turn off the welfare taps by September and also lift the ban on evictions and the temporary holidays on residential and commercial rents, and on mortgage repayments.

Magically ending all of these policies smoothly by September without dire consequences will need a miracle.

Ashley Owen is Chief Investment Officer at advisory firm Stanford Brown and The Lunar Group. He is also a Director of Third Link Investment Managers, a fund that supports Australian charities. This article is for general information purposes only and does not consider the circumstances of any individual.

Which companies will do well in the turmoil of 2020?

Hugh Dive

The upcoming August 2020 reporting season will be one of the more difficult for listed companies with lock-downs and travel bans seeing sharp and unexpected falls in revenue. Uncertainty as to when economies globally will open up and the impact of high unemployment make it difficult for companies to forecast future profits.

This season will be the toughest since 2008, though probably not as bad as 1992, which was the last time the Australian unemployment rate was above 10%. In 1992 Westpac came close to going under and ANZ Bank recorded a $1 billion loss in the aftermath of the early 1990s property crash and bad loans to 1980s entrepreneurs.

However, reporting season won't be uniformly grim for Australian companies. In this piece we are going to look at the few potential bright spots in upcoming profit reporting season.

Hardware therapy

The quarantining associated with Covid-19 has seen a significant increase in consumers staying home with time to fix household jobs that could more easily be put off on weekends when family commitments, outings and sports beckon. The Covid-19 crisis has been a boon for industries such as pest exterminators, with house-bound workers more aware of spider, cockroach and ant issues that become more urgent when reported in real-time by one's spouse.

Similarly, hardware stores have seen solid sales as individuals with time on their hands tackled postponed DIY projects. In early June, Wesfarmers (ASX:WES) reported that sales were up +19% in 2020, a significant gain for a company that dominates Australian hardware with a market share of over 50%. Wesfarmers also benefited from working from home during Covid-19 with their Officeworks division seeing sales up +28% in 2020 as printers, stationery and computers flew out the door.

Staying home with electronics

Electrical retailers JB Hi-Fi (ASX:JBH) and Harvey Norman (ASX:HVN) were deemed 'essential services' during the Covid-19 lockdown. Foot traffic in their stores was as busy as supermarkets, despite operating in shopping centres with most other retailers closed.

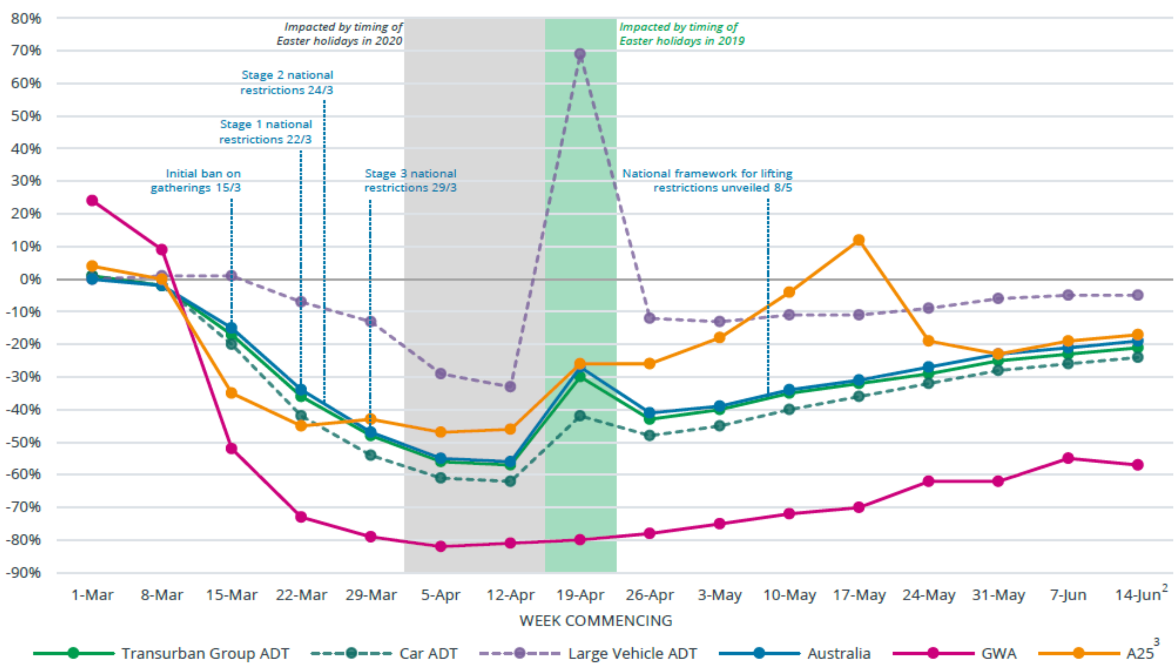
I visited JB Hi-Fi several times to buy electronic devices, computer games, and products to boost my home wi-fi that was struggling to accommodate two working adults and three home-learning children. In 2020 JB Hi-Fi reported sales growth of 20%, a solid outcome given 10 of the company's 303 stores had been closed. Also, the company reported that its white-goods focused chain the Good Guys saw sales up +24%, indicating that consumers were diverting funds typically spent on travel to improving their home environment.

Avoiding public transport

While toll road owner Transurban (ASX:TCL) has not benefited from Covid-19, unlike other 'travel stocks' it has recovered far quicker than expected from the shut down in the economy. In March the media painted a doomsday scenario for Transurban, with roads empty for months due to social distancing – similar to what Sydney Airport Holdings (ASX:SYD) is now experiencing with passenger volumes still at 3% of the monthly average seen in 2019.

Traffic did fall in late March and early April but has recovered sharply to around 80% of pre-Covid-19 volumes, with many commuters choosing to drive to work rather than use public transport. Heavy vehicle traffic that attracts 3 times the tolls compared to cars barely fell during Covid-19, as construction continued and online shopping supported traffic numbers. Indeed in Sydney, the average daily volume of trucks on Transurban's Sydney toll roads is now above where they were in February 2020.

Weekly traffic performance by geography and vehicle class[1]



Food glorious food

Grocers Woolworths (ASX:WOW), Metcash (ASX:MTS) and Coles (ASX:COL) have seen record sales growth in 2020 as quarantining, restaurant closures, and hoarding of staples saw shoppers flock to their supermarkets. Similarly, without pubs and restaurants open for business bottle shops were deemed an 'essential service', with Woolworths' BWS and Coles' Liquorland being the sole port of call for the nation's drinkers. In March, Coles placed a daily purchase limit of either a case of beer or three bottles of wine.

In 2020 Woolworths reported supermarket sales growth of 10% and liquor sales up +15%. This is impressive growth for a company that, due to the size of its market share, generally is only able to grow sales at around Australian GDP growth. However for Woolworths, 2020 earnings are projected to match last years. Higher sales will likely be offset by increased costs to serve customers, as well as the impact of the company's 294 hotels being closed.

As restrictions ease and restaurants re-open, this sales growth is likely to moderate. It is worth noting that historically, higher levels of unemployment have had a positive impact for grocery sales, as more price-conscious consumers cook at home rather than visiting restaurants and cafes.

Blood from a stone

Biotherapy company CSL (ASX:CSL) which is the second-largest company on the ASX, sells life-saving medical products and vaccines that are generally unaffected by economic cycles. However, unlike other pharmaceutical companies such as Merck or Pfizer, CSL's products are derived from blood plasma sourced from donors. This is different from giving blood as a large amount of blood is removed from the donor, the blood plasma separated in a centrifuge, and then the protein-depleted blood is returned to the donor.

Around 70% of the global blood plasma is sourced from donors in the USA which, unlike Australia, allows companies to pay donors around $50 a visit to collect blood plasma. Due to social distancing and the wider impacts of the pandemic in the US, we would expect CSL's collections to be down in 2020, thus impacting earnings in 2021. However rising US unemployment is likely to result in increasing collections over the next few years. During the GFC, CSL saw both higher volumes of plasma being collected through their network of 200+ centres and reduced the payment for donations.

Services going unused

As a result of lockdowns across Australia, there has been a significant decline in hospital admissions, as elective surgery is deferred and the number of accidents has decreased. In May, private hospital surgical admissions fell by 21% (vs long term average of +2.4%) reflecting the impact of the COVID-19 slowdown. With hospital admissions down meaningfully in 2020 and private health insurance premiums paid upfront, private health insurers NIB (ASX:NHF) and Medibank Private (ASX:MPL) should show solid profit growth for 2020 in August. However, this earnings tailwind should begin to reverse as delayed elective surgery is rescheduled for 2021.

Similarly, motor vehicle insurers Suncorp (ASX:SUN) and IAG (ASX:IAG) will see higher earnings in 2020 from a fall in motor vehicle accidents. In May Suncorp reported a 25% decline in motor vehicle claims from March to June, mirroring the 15% reduction (or 77 fewer deaths) in the national road toll in 2020 compared with first five months of 2019. Additionally, we would be very surprised if insurance claims related to crime were not meaningfully down on 2019, an empty house is far more attractive to burglars than one filled with quarantined householders!

Conclusion on winners and losers

While the shutting down of Australia's borders to international travellers and quarantine measures will be damaging to certain sectors of the economy, it is not uniformly negative for all companies. Australians actually spend more on international travel than international travellers spend here. According to Austrade, in 2019 Australians took 9.9 million international trips spending A$63 billion, whereas foreign tourists spent only $47 billion in Australia. With international travel bans likely to be extended into 2021, a portion of the expenditure previously benefiting hotels and merchants in Bali, Whistler and Tuscany are likely to be spent on home improvement and entertainment as well as domestic travel.

Hugh Dive is Chief Investment Officer of Atlas Funds Management. This article is for general information only and does not consider the circumstances of any investor.

Six types of big data are unlocking real insights

Michael Recce

The use of big data in investment management has been revolutionary, but harnessing its potential is the next big challenge for the active asset management industry. Big data is the residue of information that we all leave behind as we buy things, sell things, browse the internet, use our smartphones and generally live our lives. Alpha, or excess returns, is not in the data itself, it is in how data is processed and creatively interrogated. Big data without data science lacks any power in uncovering insights that can deliver real alpha.

It all depends how the data is used

Despite the buzz that big data is generating within the research-driven world of finance and investment, achieving an integrated approach to using it is far from easy. Alternative data can be opaque or even misleading. Amid the hype, many will forget that big data is of little use without the combined insights of experienced data scientists and investment professionals.

So-called 'big data' is proliferating. At the same time, advances in cloud computing, machine learning and artificial intelligence allow extraction of coherent, strategic insights from these digital residues. Combined, as data science, they have the potential to be a richly-enhanced source of information about our world. It is information that is deeper and more detailed than we have ever had before, and yet also broader and more comprehensive.

In simple terms, data science potentially brings unique insights into the inner workings of a company under diligence. Most investors wait for quarterly earnings updates or an occasional meeting with an executive. Data science now enables tracking in near real-time the sales of a company and its competitors, the morale of its employees and their view of the CEO, how a new product launch is being received in a given market, research and development budgets, as well as numerous other key performance indicators.

These insights, sometimes unknown even to the company itself, give an advantage over the competition as they allow for a differentiated view of the company's earnings power, or at the very least minimise impairment risk. Data science often provides insight into the operation of a business at a deeper level than is communicated more broadly, and in public reports.

Examples of big data opportunities

For example, credit card data is a popular form of alternative data but often it is used to infer total top line revenue in a quarter. This can contain significant bias and errors. Data science provides methods to detect and correct bias. In addition, statistical methods can be used to reveal demographics and psychographics in the data. Classifications of the data panel members by gender, age, urban density, income band, and buying preferences, etc. can be revealing about the cohorts and composition of the customer base and growth areas of a business. When evaluating a company it is important to know if the growth is from more customers, or from more loyalty spend by the same customers.

Online activity is another source of data science insight. Searching for something that a customer intends to buy is a leading indicator of the actual purchase. This leading indicator is particularly useful for higher cost items that are often considered for weeks before a purchase. Online transactions also provide insight into the competitive environment that the company of interest operates in, as well as a measure of the advertising spend in various channels.

Job listings provide a wealth of insight into the way that companies are growing, but this involves the use of data science methods to analyze the text of the job description. The descriptions show the areas and geographies where the company is growing, and within the text the company often signals the products from other business that they prefer to use.

Six categories of opportunities

Overall, many of the data science research hypotheses fall into one of the following six analytical categories:

- Competitive Threat - "Are Amazon's new batteries eating into Energizer's market?"
- Customer Mix - "Are men really going to buy clothes from Lululemon?"
- Customer Loyalty - "Are rewarded customers good customers?"
- New Business Initiative - "How do customers like the new-look McDonald's?"
- Pre-IPO - "Why did we doubt that investors would pick up Lyft and Uber?"
- ESG - "Is Comcast a good place to work?"

Three years ago, we added a data science capability to its team of nearly 650 investment professionals. While many in the firm have come to quickly embrace data science, the recently-launched Global Equities Data-science Integrated strategy (or 'GEDI' for short) is the first to fully integrate data science with fundamental research and ESG engagement.

Of course, different strategists working to different time horizons will make different buy and sell decisions, but whatever they do, they will now be informed, to a greater or lesser extent, by the additional depth and breadth that these data science insights bring.

State Super's senior investment manager, Andrew Huang, said of these new data-based techniques:

"To us, Neuberger Berman appears to be meaningfully ahead of the curve in building and implementing this approach. We believe that supporting fundamental research with a solid data-science and ESG discipline will be a growing advantage over time".

Data science is not a replacement for traditional investment research, but a complement that brings a fresh and sometimes counter-intuitive perspective. It is not a technology support function for investment professionals but an extension of what they already do. For the same reasons, simply hiring a team of data scientists and setting them to work is not necessarily going to enhance an investment manager's search for alpha. Finding a common language with which to integrate that team into the existing research flow that investment teams generate is critical.

Ultimately, we believe those who engage with big data seriously and ethically will find it transformative.

Michael Recce is Chief Data Scientist at Neuberger Berman, a sponsor of Firstlinks. This material is provided for information purposes only and nothing herein constitutes investment, legal, accounting or tax advice, or a recommendation to buy, sell or hold a security. It does not consider the circumstances of any investor.

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Will value stocks benefit from the market's inflection point?

Stephen Bruce

Two dominant investment styles are value versus growth. Value investors look for undervalued stocks while growth investors prefer companies with strong earnings growth potential. While value investing has outperformed over the long term, its underperformance in recent years, particularly in the recent selloff, has caused many to question when the promised value recovery will occur.

To shed some light on this, it is helpful to understand when value has outperformed in the past and the market conditions that led to this.

Where are the value stocks?

Value stocks are typically found in the more cyclical parts of the market such as the Financials, Resources and Consumer Discretionary sectors. These stocks are more sensitive to broader economic conditions, compared to defensive sectors such as Healthcare, Utilities, and Consumer Staples.

Value stocks tend to outperform when economic conditions are improving. In such an environment, the earnings growth outlook from the cyclical parts of the market improves relative to defensive sectors. This drives a rotation out of defensives and into cyclicals, leading to a period of relative outperformance by value.

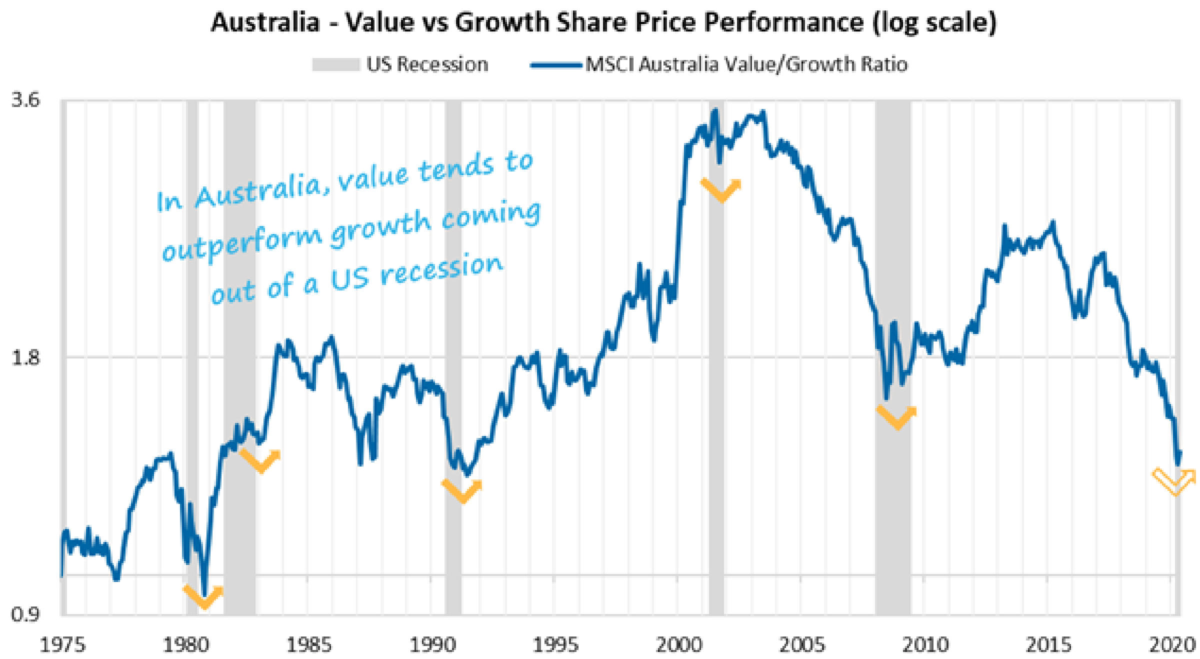
The second point is that value stocks typically perform better in a rising interest rate environment. This is the result of two factors.

Firstly, rising interest rates usually correspond with improving economic conditions, which as mentioned above, generally favours value.

Secondly, rising interest rates increase the discount rate applied to future earnings and in general, 'growthier' stocks are more impacted as a greater proportion of their valuation is based on long-term future earnings. Therefore, a higher discount rate has a bigger impact on the valuation of growth stocks than it does on value stocks, which are more driven by nearer-term earnings and dividends.

In light of this, it's easy to see why the past few years have been difficult for value investing, as global economic growth has been patchy, and we have been in a lower for longer interest rate environment.

The chart below shows how value stocks do better coming out of recessions, but how much growth has won in recent years.



This environment has been very favourable to stocks offering perceived defensive characteristics, such as infrastructure, or strong organic growth, such as healthcare. Valuations of these types of stocks have pushed up to high levels, both in absolute terms and versus their own historical valuation metrics. At the same time, value stocks have lagged and the valuation gap between cheap and expensive stocks is currently at record levels.

Value fighting back

In the second half of 2019, it appeared there was some light at the end of the tunnel. Global growth was starting to pick up, led by the US, as trade tensions eased and the UK election saw a resolution of the Brexit impasse. Bond yields were starting to tick up and value began logging several months of outperformance.

However, the COVID-19 pandemic put a halt to this, seeing economic growth collapse, interest rates slashed, and investors taking flight to 'safe haven' stocks. These factors predictably saw value underperform during the sell-off.

Tellingly, however, since its bottom in late March, the market has rallied sharply, led by cyclicals, and value outperformed strongly in April and May. Over this period, the Perennial Value Australian Shares Trust (PVAST) delivered a return of 19.9% versus the 14.1% return of the benchmark S&P/ASX 300 index. We believe the fund's 'true to label' value approach was an important driver of outperformance during the rally.

The key point is that value tends to outperform not when a crisis is unfolding, but rather, in its aftermath. This is when either the bubbles of euphoria that had been driving the market up may have burst, or the fears that had driven the market down have been realised and dealt with. At this point, investors form the conclusion that the economy will recover, and life will go on. They then seek out solid, reliable, reasonably priced businesses to invest in – in other words, they look to value stocks.

These periods have also shown that style rotation, when it occurs, can happen sharply. When valuation dispersion reaches extreme levels, such as we are seeing today, something usually gives and mean reversion kicks in, resulting in a period of strong outperformance for value investing.

If current trends continue, then the impacts from COVID-19 may be less severe than feared and economies may bounce back. If this is the case, we will have an improving economic outlook, interest rates already at extremely low levels and unlikely to go any lower, and valuation dispersion at record levels. In effect, all the preconditions would be in place for a rotation to value.

Not only does maintaining an exposure to value alongside other styles provide a form of diversification in a portfolio, but after a long period in the wilderness, the tide may be turning in value's favour.

Stephen Bruce is a Director of Perennial Value Management and Portfolio Manager of the Perennial Value Australian Shares Trust. This article is general information and does not consider the circumstances of any investor.

How Austria's century bond could end up like Argentina's

Jonathan Rochford

In June 2017, Argentina sold US$2.75 billion of 100-year bonds at a yield of 7.92%. At the time I wrote that this was crazy and reflected a desperate chase for yield that had spilled over into emerging market debt. Now that Argentina has defaulted, for the fifth time in the last 40 years, its bonds are trading at around 40% of their face value.

Just over a week ago, Austria sold €2 billion of 100-year bonds at a 0.88% yield. So, what would it take for Austria's bonds to trade at the same price as Argentina's?

It's not all about the credit

Those who are familiar with the credit profiles of the respective nations might think I'm crazy to make such a comparison. It's a fair point as Argentina had a B rating from S&P in 2017 and Austria currently has a AA+ rating. I'm not going to argue that Austria has meaningful default risk now, though over 100 years almost anything could happen.

Rather, I'm thinking about what a change in interest rate expectations could do to Austria's century bond price.

We obviously live in a world where almost no one has any expectation of central banks lifting overnight rates soon. Low growth forecasts and low inflation expectations are widely assumed. However, the enormous amount of quantitative easing, the structural weaknesses of the European Union and/or the expected surge in government debt to GDP ratios could change the outlook. Given we are talking about 100 years this doesn't need to happen in the short or medium term to have a substantial impact on long-term bond yields and prices.

Another risk is that economists, politicians and central bankers start to acknowledge that low interest rates and quantitative easing are short-term gain at the cost of substantial long-term pain. Inflated asset prices, debt bubbles, zombie companies, depressed economic growth and greater boom/bust cycles are all associated with current central bank policy settings.

Just as many learnt about Minsky cycles after the credit crash in 2007-2009, so many are starting to learn about the long-held positions of the Austrian economic school now. Keynesian and Modern Monetary Theory (MMT) economics are the establishment position currently. However, as major economies continue to be stuck in funks lasting decades (think Japan and Europe) the search for a better solution will grow.

The policy prescriptions of Austrian school economics have served Western economies well for hundreds of years and have created enormous growth in the living standards of their citizens. Those who care to look past the short term almost always become proponents of its key tenants of small government with limited interference in the economy, a strongly competitive private sector and a focus on freeing individuals to pursue their own prosperity.

It would be supremely ironic if a return to the wisdom of Austrian school economics brought about a crash in the price of century bonds issued by Austria!

The extraordinary price falls from rate rises on a 100-year bond

It's time to conduct some simple modelling of what impact this would have on bond prices.

First, the small moves, where a 1 basis point change (i.e. from 0.88% to 0.89% yield) results in a 0.66% drop in the bond price. Or a 10 basis point (0.10%) increase in the yield on this bond results in a 6.37% drop in the bond price.

Second, if we start to consider substantial shifts in yields, which might occur after a build-up of evidence of a V-shaped recovery, then the bond falls by 27.1% and 45% for a 0.50%/1.00% increase in yield respectively.

That's right. A 1% rate rise and the price falls by almost half. These would be enormous losses that many investors in government bond portfolios would be horrified to see.

Lastly, some interest rate regime change scenarios, which could occur as a result of inflation spiking or central banks normalising monetary policy. A 1.50% increase in yield, from 0.88% to 2.38%, sees a 57.1% drop in the bond price.

That's the same ballpark as the fall in Argentina's bond price. A normalisation of rates to 4% or 5% would see the bond price fall by 76.5% and 81.8% respectively. Those outcomes would be slightly worse than an average corporate bond default with a recovery rate of around 35%.

All while Austria remains a strong credit.

Jonathan Rochford, CFA, is Portfolio Manager for [Narrow Road Capital](). This article contains general information only and is not a substitute for professional and tailored financial advice.

Five industries profoundly changed by COVID-19

Angus McLeod

Four months have passed since the country and the world were rocked by a pandemic not seen in the lifetime of almost everyone. The virus has caused a major shake-up in the way we work, play, shop and live. There will be huge ramifications for many years to come in almost every aspect of life in the developed economies.

We are all acutely aware of how the virus has affected us personally. In this article, I review the ramifications through the lens of one part of the research done back in 1979 by Michael Porter at Harvard Business School. Porter devised a way of analysing a business by looking at Five Forces which act on it:

- the threat of new entrants
- the power of buyers
- the power of suppliers
- the rivalry in the industry, and
- the threat posed by substitute products.

It's this last one that I use most to make some predictions on the future of the economy.

Better, easier, cheaper

The threat of substitution comes from customers finding a different way of doing what a business previously did for them. In the case of the virus, various government regulations and lockdowns have compelled consumers to find new ways of running their lives.

Here are five industries that may be profoundly changed by the threat of substitutes.

1. Restaurants

Cafés, food shops and restaurants were effectively closed for months. Many people have learned a new skill: cooking for themselves. They have learned that it's not that hard to create a tasty meal at home for a fraction of the cost of eating out. Home-cooked food is healthier, can have more variety, can bring families closer together and can save a lot of money. Sure, there are plenty of things that a home cook cannot do but with the lockdown pushing people into the kitchen, many local restaurants which will have to compete against substitute meals cooked at home. Why get a steak at a pub for $30 when you can make one at home for around $6?

Equally threatening, it will be a long time until the social distancing rule of four square metres is relaxed and many restaurants cannot survive devoting so much space to each person.

2. Pubs

Judging by the queues at Dan Murphy's, people still like to have a drink. With local pubs closed there was nowhere else to venture for a drink but to the bottle shop. And people certainly did venture there. For the price of a pint of beer at the local hotel, people bought four cans of beer at an off-licence. That's a huge cost differential just to be served a drink in a glass.

And yes, there's a large social element to meeting at the local pub but for the cost-conscious, the saving from staying home is material. And a big bonus is that you don't have to travel home afterwards. Pubs will have some hard work and maybe some margin shedding to do in order to bring back customers in the same numbers as before, socially-distanced apart.

3. Gymnasiums

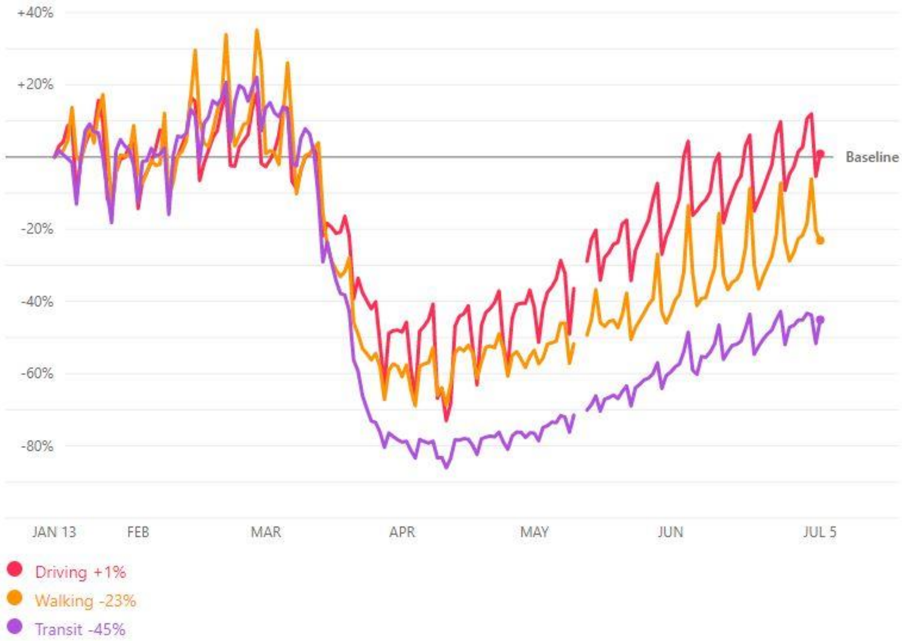
It's possible that all the home cooking and backyard drinking has put people off gyms completely. Thirteen weeks away from exercise could be the end of a fitness regime for many. But those who maintained their exercise routine while the gyms were closed might have found that their monthly subscription fee was better spent on their own equipment that could be used around the home or in the local park. There are plenty of media stories about people setting up home gyms.

Others may have learned that the treadmill, while it does have a TV and iPod connection, isn't as much fun as pounding the pavement in your local area. Outside exercise was one of the few excuses allowed for escaping the lockups. My gym has halved fees during the reintroduction period but they're going to have to do more than that to regain the level of attendance they once enjoyed. The convenience of your own backyard or local park, compared with making the trip to the gym, may be hard to overcome, especially as JobKeeper and JobSeeker benefits are wound back and the purse strings tighten.

4. CBD office space

Early in the pandemic the sales teams at Officeworks and JB Hi Fi could barely keep up with demand as the home office fit outs began in earnest. Office workers now do everything they used to do from the comfort of their home and, if some recent surveys are any indication, many are not keen to revert to the daily commute to the city any time soon.

Consider the Google Mobility Trends on how slowly Australians are returning to the office, with time spent in transit (the purpple line) still 50% less than normal.



As the virus is recurring in some places, with Metropolitan Melbourne returning to lockdown, life as we knew it seems a long way off. So what is in store for city office space? The cube farm has been replaced by the home office, delighting many workers but doubtless worrying a few commercial property executives who may be wondering how much space will be required by firms when their leases come up for renewal.

5. Air travel

There was a time when the Melbourne-Sydney route was among the busiest in the world with over 54,000 take-offs (and landings!) a year. Now Virgin is struggling and Qantas is slashing staff. The majority of travel was there-and-back business travel. Coronavirus has put a stop to that, and the face-to-face meeting has been replaced by the videoconference. The savings to firms have been massive with one organisation I know slashing their travel bill by over 90%, saving nearly $17,000,000 per year. How can the airlines compete with that?

The productivity increases for firms from not having staff away from the office for a day to attend a two-hour meeting, on top of the flight costs, are unbelievably large. After sustaining the revenue attack from the virus, airlines will be hard-pressed to lower costs enough to entice business travel back to anywhere near the level it was before COVID.

History as a guide

Back in the 1930s the Dupont company was the first to successfully create and sell fully man-made fibre and the market for nylon was born. Very quickly demand for natural silk was decimated and by the late 1940s the market for silk hosiery was almost entirely replaced by nylon. This is one example of the power of substitutes on a company's fortunes.

Will we see a similar game of substitution play out in the wake of the coronavirus pandemic of 2020? While the use of the alternatives I've mentioned was driven by necessity, one of the prime motivators that will help to maintain their use is the considerable cost savings to be had by not reverting to the original product.

Just as nylon cut the cost of silk and vinyl cut the cost of leather, the substitutes for restaurants, pubs, gyms, offices and air travel have put more money back in consumers' pockets. And with the economy in its current state, it might be impossible to get that money out again.

Angus McLeod writes for The Money Question blog, he is also a lecturer in the Master of Finance course at RMIT University and a former fund manager.

Wirecard shows not all ethical ETFs pass the smell test

Richard Montgomery

Last week, German payments giant Wirecard filed for insolvency, owing creditors almost $5.8 billion. The company's collapse came a week after its auditor, Ernst and Young (EY), found a massive $3.1 billion hole in its books. EY refused to sign off on the company's 2019 accounts, saying there were indications of an "elaborate and sophisticated fraud involving multiple parties around the world".

Markus Braun, the firm's CEO, resigned and was subsequently arrested on suspicion of misrepresenting the firm's finances.

Wirecard's implosion is a stunning fall from grace for a company that was once seen as a champion of the European technology industry. So how is the demise of a German fintech company relevant to Australian investors?

While it's likely that relatively few Australian investors will have had direct exposure to Wirecard, it's possible that significantly more had exposure via a managed fund or ETF. The holders of broad sharemarket funds may be relatively sanguine about an event such as this, accepting that broad sharemarket exposure inevitably involves 'taking the bad with the good'.

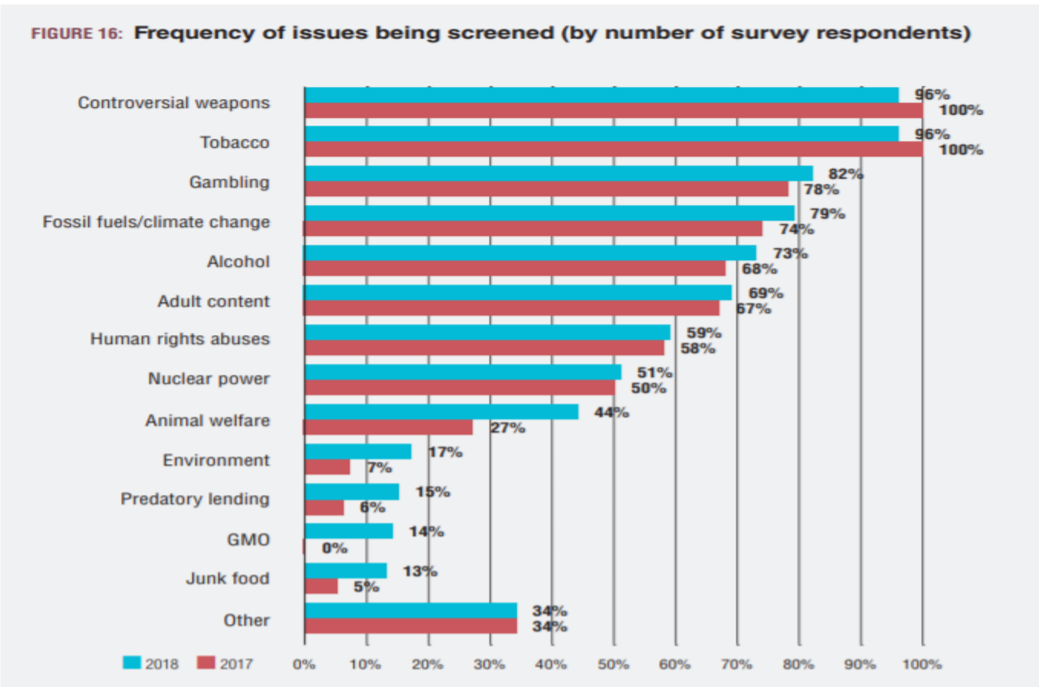
However, for one rapidly-growing class of people, investing their money in businesses whose environmental, social and governance (ESG) standards are beyond reproach is non-negotiable. For these investors, a true-to-label ethical exposure is one of the most important factors to be considered in their investment choices.

What do we know about Wirecard?

Wirecard offers products and services in the areas of mobile payments, e-commerce, digitisation and finance technology. It is also one of the popular options consumers can use to gamble online. Once an account is set up with Wirecard, it can be loaded with funds from a credit or debit card, or from a bank account. Account holders can use Wirecard to move money to and from online casinos, without having to disclose their banking information.

In a report by the Financial Times, Wirecard acknowledged that up to 10% of its payment volumes "relate to lottery, gambling, dating, adult entertainment and associated business models".

In its *Responsible Investment Benchmark Report 2019*, the Responsible Investment Association Australasia (RIAA) found that 82% of the responsible investment managers surveyed said they screened investments for gambling (see figure below).



Source: *Responsible Investment Benchmark Report 2019,* RIAA.

True-to-label ethical exposure?

For investors who are concerned about the true-to-label exposure of their ethical investments, it's essential to have confidence that an ethical fund is screening out investments that do not align with their values.

Our global equities-focused ethical ETF (ASX:ETHI) aims to track an index that applies limits to the percentage of a company's revenue that can be derived from activities deemed inconsistent with responsible investment considerations. These exposure limit guidelines include a limit of 0% for casinos and manufacture of gaming products and 5% for distribution of gambling products.

Due to its involvement in gambling, Wirecard did not pass ETHI's index screening process and was not included in its portfolio. It was estimated that well over 5% of Wirecard's revenue was derived from providing payment services to online gambling, poker tournaments, and sports betting platforms.

Wirecard was also excluded from other ASX-traded ethical ETFs, but not all.

The performance of a number of ethical equity-focused ETFs has been strong, inclduing ETHI. However, we believe that one of the primary reasons that investors (both institutional and individual) have favoured our ethical funds is the integrity and quality of the investment methodology our funds employ.

In addition, the Betashares Responsible Investment Committee may, applying the ESG-related screening criteria, exclude a company exposed to significant ESG-related reputational risk or controversy, if it considers that its inclusion would be inconsistent with the values of the underlying index.

The strictness of screening processes can vary between ethical ETFs, and many ethical ETFs rely on off-the-shelf indices without additional oversight. This can result in stock inclusions that may not pass the ethical 'smell test' and would be out of place for many investors seeking an ethical exposure.

For example, the French beauty giant L'Oréal is currently a constituent in some ethical ETFs trading on the ASX. This company conducts animal testing for cosmetic purposes and has received a "Fail" grade from the influential Ethical Consumer Guide. L'Oréal was screened out of ETHI's portfolio based upon its record on animal welfare.

In the last two years, other stocks screened out of ETHI but included in the portfolios of other ethical ETFs traded on the ASX include Halliburton, Schlumberger, Barrick Gold, Valero and Kering. We believe ethical investors may not be comfortable with these companies for reasons such as environmental degradation, fossil fuel exposure, animal cruelty, junk food, bribery, fraud, tax evasion and breaking trade sanctions.

Not all ethical funds are created equally

The Wirecard episode demonstrates the importance of understanding what lies 'under the hood' of an ethical ETF. There can be significant differences between fund methodologies, and as a consequence, in the ability of different funds to deliver on their promise of offering ethically screened portfolios that align with the values of ethical investors.

Richard Montgomery is the Marketing Communications Manager at BetaShares, a sponsor of Firstlinks. This article is for general information purposes only and does not address the needs of any individual. Past performance is not indicative of future performance. Investment value can go down as well as up. For more articles and papers from BetaShares, please click here.

**ETHI is certified by RIAA according to the strict operational and disclosure practices required under the Responsible Investment Certification Program. The Responsible Investment Certification Program does not constitute financial product advice. Neither the Certification Symbol nor RIAA recommends to any person that any financial product is a suitable investment or that returns are guaranteed. Appropriate professional advice should be sought prior to making an investment decision. RIAA does not hold an Australian Financial Services Licence. www.responsibleinvestment.org.*

What should you look for when investing in private debt?

As the Australian and global economies stare down the barrel of recovery from a COVID-19 world, many predictions have been made about which businesses will survive beyond the recovery phase. One area of concern has been the severe impact this downturn will have on the Small to Mid-market (SME) business sector.

These borrowers typically have less access to capital than the big end of town and while they may be a focus of government stimulus (such as JobKeeper), it is hard to command the attention or intervention of governments in the same way that Virgin Australia did many weeks ago. Additionally, the prevalence of cheap money due to low rates and low-to-no covenant loans has created concerns that there are many 'zombie companies' operating across Australia whose existence are only propped up by such loans.

These are valid concerns and there will likely be some pain across many sectors of the economy over the coming months as conditions lay bare some of these structural deficiencies. At the same time, many attractive risk-adjusted lending opportunities will become available as markets and economies re-balance.

Critical considerations for lenders

Many of these predictions, while valid, short-change the opportunity in the SME sector to lend to the many well-run, well-capitalised cash generating businesses across Australia. Although smaller than their large-cap peers, that does not preclude the existence of robust businesses in the SME sector backed by good governance, strong management teams, operational integrity, strong margins and a sound balance sheet.

The key to any good business loan is these key criteria:

- **Cash flow**: the business has the cash flow required to service any loan undertaken, while still able to invest in the operational and capital expenditures required for the business.
- **Character**: the business is a well-run organisation with a quality and engaged management team with skin in the game and strong governance systems in place.
- **Collateral**: the business is backed by a sound balance sheet with the appropriate business assets to securitise the loan in the case of required recovery action.

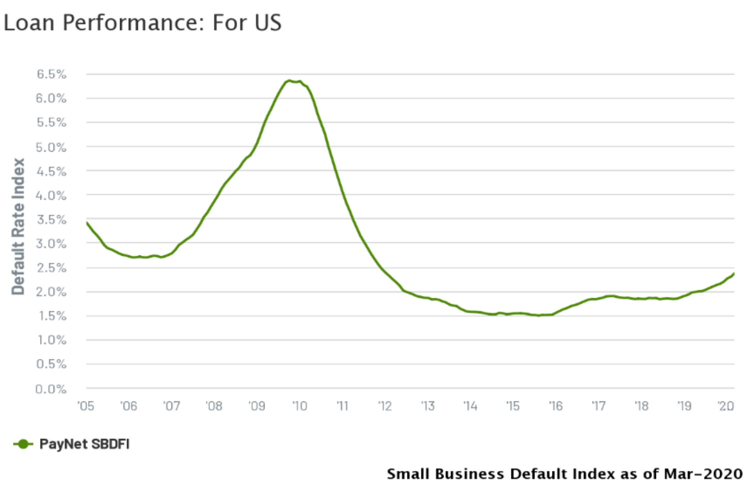
What does the data tell us about lending to this sector?

Based on historical default data, what default risk might be expected in the SME debt markets in general over the period ahead? To work that out, we look at:

- The SBDFI: while not an Australian indicator (there is no such equivalent publicly available), the Small Business Default Index (SBDFI) in the United States is a good leading indicator of the US economy and marker of historical and current default rates for small businesses.
- ASIC's Australian insolvency statistics: which provide monthly data on the number of Australian companies which have entered a form of administration for the first time each month.
- Historical default rates on corporate bonds: while corporate bonds reflect mostly large cap companies (as opposed to SMEs), they give a good proxy and overview of how the credit markets have behaved at particular points in time.

SBDFI

The chart below shows the annualised rate of small business defaults in the US since 2005.

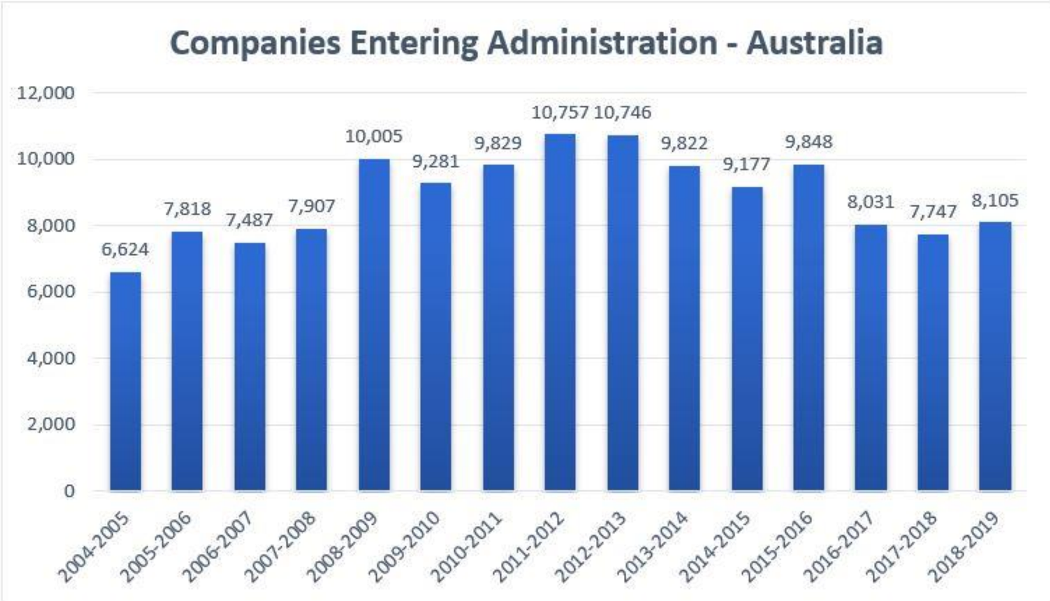


Source: PayNet

Unsurprisingly, the chart peaked in late 2009 at just under 6.5% during the height of the GFC. This represented an almost 2.5x increase in defaults on mid-2006 of just 2.69%. The default rate has been steadily increasing since 2016 with the beginnings of a potential rise into early 2020. The latest figures from March 2020 shows a 2.36% default rate which is up about 0.50% on March 2019. It is likely that this will continue to grow as the economic impacts of COVID-19 mount in the coming months.

Australian insolvency statistics

The chart below shows the number of companies in Australia that have entered external administration since FY 04-05.



Source: ASIC

Looking back to the GFC, around 2008, there was a significant jump in companies entering administration from the previous year (about a 27% increase). These numbers then fell in the subsequent two years (however were still above the pre-GFC high) as some were able to keep afloat due to Government and monetary policy stimuli.

It wasn't until FY12/13 and FY13/14 that the number of administrations peaked as businesses that likely benefited from significant stimulus packages began to struggle as fiscal and monetary policy tightened exposing some 'zombie' businesses propped up by those policies.

The takeaway here is that with significant government spending and quantitative easing from the RBA occurring during the COVID-19 crisis, the actual effects may not be felt for months or years down the track by zombie businesses protected by these policies. The default data is therefore a lagging indicator of economic activity.

Default Rates

	AAA	AA	A	BBB	BB	B	CCC
Rate of default (High)	0.00%	0.38%	0.39%	1.01%	4.22%	13.84%	49.46%
Rate of default (Med)	0.00%	0.00%	0.00%	0.07%	0.58%	3.40%	23.79%
Rate of default (low)	0.00%	0.00%	0.00%	0.00%	0.00%	0.25%	6.67%

Source: S&P

Median Recovery Rate Senior Secured Loans: 100%
Median recovery Rate Senior Unsecured Bonds: 21.5%
Median recovery Rate Jnr Subordinated Bonds: 0.3%

Source: Moody's

The tables above outline the rates of default by investment rating over the last 40 years and the median recovery rate of loans (regardless of rating) by where they sit in the capital structure.

For AAA to A rated loans, there is a relatively small difference between annual rates of default in their best years versus worst. Once entering the sub-investment grade level, the differences become higher, however, BBB and BB rated bonds still had a maximum default rate of 4.22% in their worst performing year (1982). Once entering junk bond territory (CCC), default rates are far more volatile reaching as high as 49.46% during the GFC.

Of these loans that did default, those which were senior secured experienced a median recovery rate of 100%.

As soon as an investor moves down the capital security stack, this rate decreases significantly to 21.5% for a senior unsecured bond.

These statistics highlight the importance of senior security status for capital preservation with any debt instruments (to larger or SME borrowers) and the ability to achieve an appropriate risk adjusted return on such investment.

The key takeaways

To summarise, some key takeaways are:

- It is vital that any lender fully understands the core cashflow, character and collateral characteristics of the business, how they are equipped to handle the current operating environment **and** their capacity to keep trading as government and monetary stimulus abates.
- While unsecured and subordinated debt can provide enticing returns for investors seeking yield, they come with significant risk. Senior security and strong cashflow foundations historically have provided investors with both income and protection of their capital. If any such debt does become impaired, having the proper security and legal structure in place gives secured lenders several alternative recovery options, where equity and subordinated debt is burned first in any recovery scenario.
- Strict investment filters, patience and deep due diligence is required to both steer through and take advantage of the opportunities that the current environment might present to senior secured lenders. This means that in this area of private debt markets, investors must be prepared to invest for a medium- to long-term horizon (i.e. 2+ years) to achieve attractive risk adjusted returns from lending to this sector in excess of 8% p.a. Additionally, managers need to have the experience and be prepared to roll up their sleeves and undertake the work required to protect an investors capital at all times.

A private debt strategy built around the three core principals of character (strong management team and businesses fundamentals), collateral (senior secured position against business assets) and cash flow (ability to service the loan and strong covenants in place to keep the borrower accountable) will provide investors with attractive risk adjusted income returns from lending to the SME/mid-market sector.

David Zipparo and Tim Davis are members of Causeway Asset Management's credit and investment team. This article is for general information only and does not take into account the circumstances of individual investors. Investors should seek financial advice before considering private debt opportunities as many structures are more suitable for sophisticated investors.