Firstlinks
a Morningstar company

Edition 367, 24 July 2020

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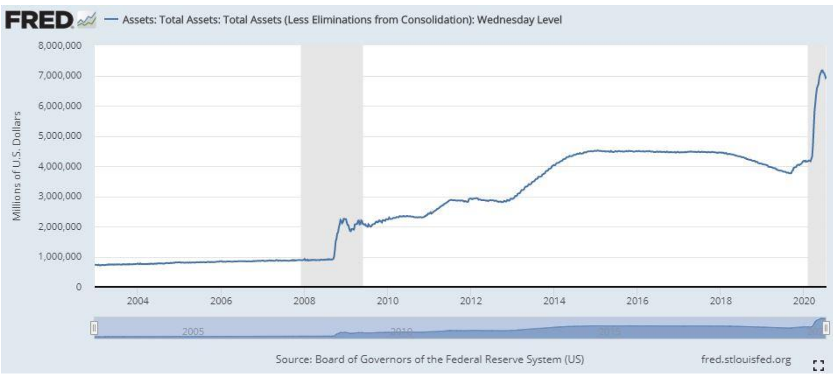
Editorial

There is a similarity between the current health crisis and economic crises of the past. For COVID-19, record amounts of biotech funding from government agencies and private companies are looking for a vaccine. Likewise, central banks once struggled treating recessions, but the 'vaccine' now is record amounts of financial stimulus to ensure liquidity. While the world awaits a COVID treatment, markets are purring along, at least until side effects hit.

In what is now considered a major economic policy mistake, during the Great Depression from 1930 to 1933, the US Fed shrank the supply of cash quickly, leaving less money in circulation and reducing liquidity for people to buy goods, services and assets. A potentially mild recession became severe with a quarter of Americans out of work. Disposable incomes fell by almost 30%.

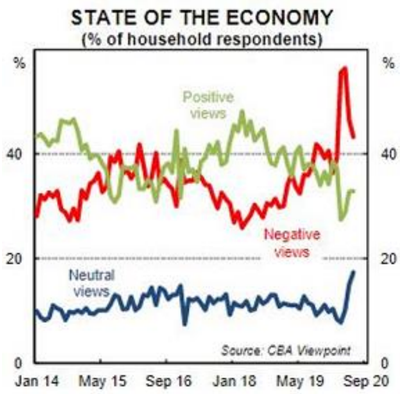
Learning how to treat that disease, central banks now throw unlimited 'whatever it takes' liquidity at the market, the latest iteration being the US Fed buying corporate bonds. The chart below shows the total assets of the US Fed, currently US$7 trillion, with the 2020 expansion making the GFC look like a blip.



In the background, we have **Modern Monetary Theory** (MMT) saying governments have no practical constraints on their spending, so they can just go hard when there are no inflationary consequences. Next, solve world poverty?

In Australia, gross government debt has reached about $850 billion and where previously a budget surplus in 2019/20 was forecast, a $90 billion deficit is now expected. The spending has a purpose and Reserve Bank Governor, **Philip Lowe**, is relaxed on the amount. The combination of JobKeeper, JobSeeker, super early release and business loans has helped retail trade, as shown below from ABS data and CBA Economics.

Individuals and the economy are benefitting. The heavy retail fall in April was followed by strength in May and June, such that Q2 2020 was only 2% lower than Q1 2020, an extraordinary result given the job losses and lockups. Negative views on the state of the economy have fallen quickly. So far, that's the economic cure, although we have yet to see the reality of poor corporate earnings in the coming season.



As with a vaccine, it remains to be seen whether there are unacceptable side effects from burgeoning government debt, but after a dozen years of liquidity injections in the US, there are few signs of inflation or limits to the size of the Fed balance sheet.

Where are we on the other cure, the vaccine? The stock market has drawn considerable enthusiasm from potential breakthroughs by US company **Moderna** and the UK's **AstraZeneca** working with **Oxford University**. China's **Sinovac**, Australia's **CSL**, big US players such as **Johnson & Johnson** and **Merck**, and German firms **CureVac** and **BioNtech** are among the leaders.

However, there is a reality check on vaccines which the market is ignoring. **Rod Skellet** reports on the company with most recent vaccine success, Merck, saying it takes much longer to develop safely than the market recognises. After approval, will governments hang on to supplies for their own people?

Next up, two of Australia's highest-profile fund managers identify stocks they like in the current market. **Matt Williams** shows the value of clever capital allocation is vital for company success, and **Paul Xiradis** reveals his favourites.

Then **Raewyn Williams** describes the conditions under which value stocks can recover lost ground versus the growth momentum, while **Christine Benz** interviews retirement expert, **Wade Pfau**, on the 4% 'safe withdrawal' rule, which has long been an industry standard for not running out of money in retirement.

In these uncertain times, **Noel Whittaker** describes new ways a portfolio can be hedged against stock market falls, and **Amit Lodha** says his reading has informed his long-term thinking more than ever during the pandemic lockdown.

This week's White Paper from **Fidelity International** focusses on the rapid growth of waste, and the investment opportunities from avoiding a devastating impact on our lives and the planet.

A hard dose reality check on vaccines

Rod Skellet

"I think when people tell the public that there's going to be a vaccine by the end of 2020, they do a grave disservice to the public ... Let me just give you one data point. In the last quarter century, there have only been seven, truly new vaccines introduced globally at the clinical practice. Merck has four, the rest of the world has three. - Ken Frazier, CEO of Merck

The level of optimism in equity markets and society in general regarding the progress on developing a vaccine for COVID-19 has certainly been increasing.

The world is desperate for vaccine updates and is putting the recovery of the economy and the reduction in the health crisis on the line. So much so, it’s like the vaccine is almost fully developed and trialled.

Personal experience with vaccines

I am not sure how many of this readership has been personally exposed to vaccines. Sure, the flu shot is common, but if people think the vaccine for COVID-19 will be like receiving a flu shot, they could be in for a very rude and thought-provoking wake-up call.

Not all vaccines are as simple and benign as the influenza virus.

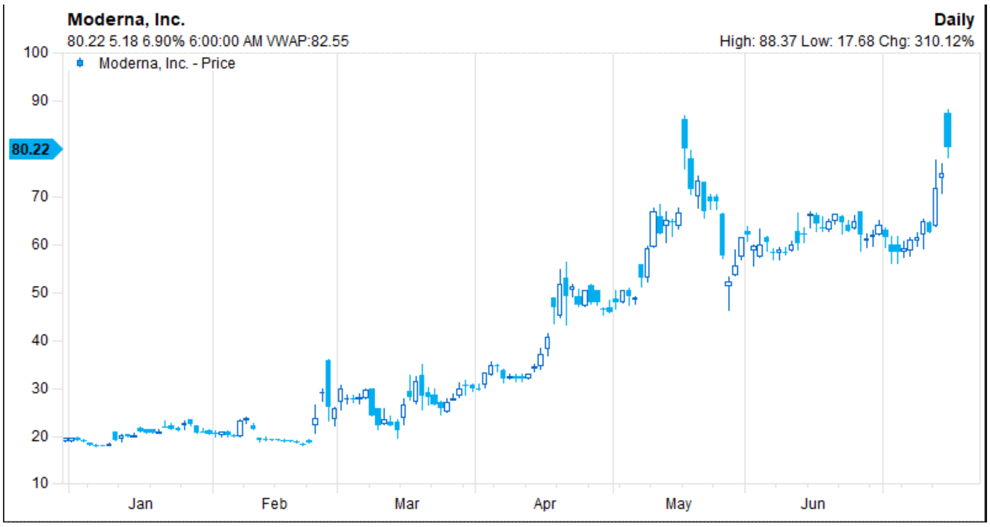
Growing up in Papua New Guinea, my entire family was given the smallpox vaccination. My father at the time in the early 1970s was 35 and he took us to the doctors to get jabbed. The negative side-effects of the smallpox injection were known at the time but we had little choice as it was a legal requirement to be inoculated prior to travelling to PNG.

The impact it had on my dad was horrible. He spent four days in hospital and three weeks in bed. He was very, very sick. If this type of side-effect is what could be expected from any COVID-19 vaccination, how many people will want a vaccination and can the hospitals cope with the negative side-effects?

The global search

The search for a vaccine is front of mind in the pharmaceutical industry, with some 160 individual programmes under way. In recent times, Moderna Inc has been in the news with some positive results from a Phase 1 clinical trial across 45 healthy adults. All participants in the trial showed an antibody response.

Antibodies are the proteins the body makes to fight infection. Being safe to use in 45 people is not the same as being safe for say 20 or 200 million people that would need vaccinations in the US alone, but the market is rewarding Moderna.



Source: Factset

A reality check on development time

Ken Frazier, CEO of pharmaceutical giant Merck, was interviewed recently by Professor Tsedal Neeley from Harvard Business School. If there was ever a rational discussion on the topic in my view, it was this.

I will summarise his interview with the following bullet points.

- Developing a vaccine takes time, a lot of time. The fastest vaccine ever brought to market was for the epidemic parotitis ('mumps'). It took Merck four years to produce this vaccine.
- The most recent vaccine created for a large viral outbreak was for the Ebola virus, which took 5.5 years.
- In the past 25 years there have been only seven truly new vaccines introduced globally. By new, that means that they were effective against a pathogen for which there had previously been no vaccine. Merck has developed four of those seven and the rest of the world three. There has been an enormous amount of work done in the field of prevention. Despite all this work, the world has been trying to develop a vaccine for AIDS since the early 1980s, and so far, without success.

- Developing a vaccine requires vigorous scientific assessment. Vaccines must be safe, effective, and durable. No one knows if any of the 160 programmes will produce a vaccine that is effective. This vaccine must work on billions of people.
- Lots of vaccines in the past have stimulated the immune system (just like the Moderna trial vaccine) but ultimately did not confer protection.
- When politicians suggest there will be a vaccine available by the end of 2020, they are doing the public a "grave disservice".
- We do not want to rush the vaccine before rigorous science is done. We do not have a good history of introducing a vaccine in the middle of a pandemic. The swine flu vaccine did more harm than good.
- While we are working hard on a vaccine, the best preventative measures to limit the spread and infection of COVID-19 are good hygiene, wearing a mask and social distancing.
- The bigger challenge to developing a vaccine is distributing it to where it is needed most. In a time of ultra-nationalism, countries want to take whatever is available and use it in their own population first rather than offering it to populations globally at greatest risk.
- Developing a vaccine for 7 billion people has never been done before. Delivering it to 7 billion people is an enormous logistical challenge, especially to those communities who cannot afford it.
- This is a global pandemic. Unless all of us are safe then none of us is safe.
- The mobility of the world's society poses a real problem. The EU has barred Americans travelling to Europe for a reason. Americans are not doing the things required to suppress the epidemic. Americans value liberty. It has been a strong theme through US politics for 200 years, largely because the US has two big oceans protecting it. This virus does not care about liberties. If people exercise liberty at the personal expense of others, then we cannot control this pandemic.
- America is 4% of the world's population and 25% of the world's infections. That's scary.
- We need politicians with enough integrity to tell the truth. This time next year we will still be experiencing what we are experiencing now. Be prepared for that.

With these sage words lingering in your mind, let's hope that when a Phase 3 trial for the Moderna vaccine gets under way, a trial that will involve thousands of patients, the results of the safety and efficacy will be such that a reliable vaccine can be developed.

Just be conscious that it will be a miracle if it is developed before the end of 2020, and if you believe Ken Frazier, 2025 is a more realistic time frame.

(The full video interview and transcript are [here](#)).

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Two great examples of why company management matters

Matt Williams

The COVID-19 crisis has delivered an historic challenge to health authorities and macroeconomic policymakers alike. For many company management teams, it has above all tested their recent decisions on how they allocate capital.

Adjectives used to describe the past 12 months are losing their meaning; unprecedented, tragic, volatile, worrisome and so on. Throw in some comments about the extraordinary levels of monetary and fiscal stimulus and there you have 99% of the commentary that will review this amazing period.

We do not know what the future looks like, but we are optimistic. Worst-case health and economic scenarios, forecast by some, have not eventuated in Australia. Let's hope that continues.

Rather than making vague prognostications on what the future holds or predicting how stock markets will react, we share some insights from our investment experience and outline how this shapes our process and portfolios.

Management and capital allocation

It has been said that we can only judge the quality of management decisions made during the good times after the cycle turns and the 'tide goes out'. Whether it be the need to:

- write down acquisitions purchased at the top of the cycle
- repair balance sheets with dilutive equity raisings and dividend cuts
- jettison assets that are now 'non core'

... the recent market dislocations have shone the spotlight on management decisions made over the past cycle.

Ultimately, we look to invest the money of our clients in companies run by executives who we trust and view as highly competent. Management teams influence the creation of shareholder value through their decisions on capital allocation.

Here are two examples that illustrate the shareholder wealth that management teams can create when they allocate capital with skill and insight.

Example 1: the battle of the plumbing wholesalers

It's not only products and business models that create wealth. Management teams make decisions on how to deploy capital and over time those decisions compound on each other leading to potentially vastly different outcomes.

Take the example of two businesses that, on the surface, operate what would seem to be similar business models (wholesale distribution) selling similar products (plumbing supplies) to similar trade customers. If we rewind back to 1998, Reece and Tradelink were generating similar earnings of roughly $20 million a year.

Now let's fast forward 20 years, a timeframe in which management decisions have compounded their effects on the outcomes for the businesses.

Figure 1: Reece and Tradelink operating earnings 1998 and 2019

Source: Airlie Funds Management

The difference is stark. Reece has produced an 18-fold largely-organic increase in earnings while Tradelink earnings have *actually fallen* over the last two decades.

What was the difference over those 20 years? We attribute it overwhelmingly to Reece management. The business has been run by members of the Wilson family for decades. They skilfully invested capital in high-returning projects to grow the business and stayed focused on core competencies with the long term in mind. We also believe the family's significant shareholding (about 75%) of the business over that period further contributed to great decisions on capital. They had 'skin in the game'.

This owner-managed structure is one we like. We have several such long-term holdings across our portfolios including Reece, Premier Investments, Mineral Resources and Nick Scali.

Example 2: Wesfarmers

If there was ever a good corporate structure in which to examine decisions on capital allocation it would have to be the conglomerate. While there has been much debate on the case for and against the conglomerate, proponents of the structure point to the ability of the corporate centre to make value-accretive capital decisions so that the whole is greater than the sum of the parts. Of course, if we invert this, the risk with the conglomerate is the company trades at a persistent discount to the sum of its parts.

We believed this was the case with Wesfarmers in mid-2016. As the share price chart in Figure 2 shows, Wesfarmers traded sideways for the best part of five years from 2013 to 2018 when return on equity was stuck around 10% (adjusting for write-downs). Few material changes had been made to the asset portfolio and the company was dealing with some poor capital-allocation decisions in relation to the expansion of Bunnings into the UK.

Our analysis indicated there was value trapped inside the collection of assets that could be unlocked and we engaged with management on these views. Around mid-2017, Rob Scott was appointed CEO of Wesfarmers and quickly made significant changes.

Rob and his team skilfully extracted Wesfarmers from the UK, demerged Coles and made other material divestments that amounted to almost $20 billion across 10 transactions. The company’s share price has rallied since this time.

Figure 2: Wesfarmers share price since 2013 ($A adj. for Coles demerger)

Source: Airlie Funds Management

It doesn’t matter until it matters … and it has really mattered this year!

Not only did Wesfarmers management adeptly capitalise on the final stages of the bull market to sell assets at good prices, it built resiliency and optionality into the balance sheet heading into the downturn. This contrasts with how the Wesfarmers balance sheet was positioned during the GFC and should bode well for the company’s ability to make value-accretive transactions at attractive prices.

This focus on the balance sheet and a company’s *financial strength* is another central component of the Airlie investment process. It helps us identify opportunities such as Wesfarmers, and avoid 'value traps' whereby valuations may seem appealing but with the wrong level of debt for the business model, a company is unable to consistently generate adequate cash flow and returns for shareholders.

Corporate debt levels haven’t seemed to matter to the market over the last few years and some management teams have been lured by cheap debt to fund buy-backs or increase dividend payouts. The economic impacts of COVID-19 have quickly changed the market's view on the importance of financial strength.

Figure 3 shows the outperformance of those stocks in the ASX200 Industrials index with low financial leverage in March and April 2020.

Figure 3: Outperformance of stocks with low financial leverage in March and April 2020
ASX 200 Industrials Total Return by Net Debt to EBITDA

Source: MST Marquee, Airlie Funds Management

The strength of 'low equitisers'

We have seen over $20 billion of equity capital raised on the ASX in the past four months to repair balance sheets. However, we believe that it is not only in the short term that financial strength matters. Over the long term, companies that are able to fund their operations, including growth, from internally generated cash flows tend to outperform those that repeatedly need to come to the market to raise equity.

This collection of companies that repeatedly require new equity capital, or 'equitisers', have underperformed by 9% p.a. relative to low equitisers on the ASX over the past 20 years. These decisions about how to fund the business tie back to management decisions on capital allocation.

Figure 4: Long-term outperformance of companies with low levels of 'equitisation'

Source: MST Marquee, Airlie Funds Management

Looking to the future

We are ultimately optimistic, even though we are unable to predict the future. The government and community response in Australia has kept us in relatively good shape. We are mindful that in the very short term, government policy responses will be key to both the health and economic outlook. Currently in Australia, the Job Keeper/Job Seeker fiscal programmes are due to be removed later this year (*update - they have now been modified and extended into 2021*). From our discussions with company executives, there is caution on the ramifications for employment and consumer spending from the removal of these programmes.

While the near-term outlook is uncertain, we have confidence in our investment process. It is robust and has been tested through multiple cycles over two decades. We continue to expect those companies with high-quality management teams and strong balance sheets to do well over the medium to long term.

Matt Williams is a Portfolio manager for Magellan-owned, [Airlie Funds Management](). Magellan Asset Management is a sponsor of Firstlinks. This article has been prepared for general information purposes only and must not be construed as investment advice or as an investment recommendation. This material does not consider your investment objectives, financial situation or particular needs.

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How we have invested during COVID-19

Paul Xiradis

This Q&A session is with Paul Xiradis, Executive Chairman, Chief Investment Officer, and Head of Equities at Ausbil.

Q: At the middle of 2020, where do we stand with COVID-19 from a macro viewpoint, and has your outlook changed?

It has been quite an incredible ride over the past few months. Back in March, we were looking into the unknown with a pandemic that was both unpredictable and dangerous. Incredibly, almost in unison, governments and central banks across the world's markets scrambled together the biggest stimulus package in history, over 10% of world GDP in value. Until then, things seemed bleak, but after this wave of stimulus, focus turned to containment and recovery.

We felt that in the second half of this year there would be a recovery, we said this early. A few months on, we are experiencing a far better outcome than most expected. This is largely due to the decisive global stimulus that supported the world economy in hibernation, and the fact that this period of hibernation has been a lot shorter than expected.

Retail spending has been a lot stronger than anticipated. Activity in construction and trade activity was a lot stronger than expected. We are seeing e-commerce driving activity levels, allowing people to continue to operate, and as a result we saw sales move up, not down. Unemployment did not peak anywhere near, at this stage at least, what the market was anticipating. Most commentators are readjusting their forecasts back to levels nowhere near as dire as first anticipated. I think this provides greater confirmation that we will see a recovery in the second half of this year, that the recession will be shallower to what we were anticipating.

In Victoria, locally acquired cases are sharply rising in Melbourne, with Stage 3 restrictions reinstated for six weeks and the closing of the Victorian and NSW state border. The swift containment measures implemented by authorities is reassuring. At this stage, this will probably be a temporary drag on economic activity through the September quarter. Meanwhile, we expect the remaining Australian states to continue with their scheduled reopening dates, enabling activity to resume, which should help to cushion, to some degree, the impact on GDP growth. At this stage, it does not change our current medium-term outlook on the expected 'U-shaped' economic recovery profile for Australia.

Q: Do you think COVID-19 has changed many sectors for good?

What COVID-19 has done is fast-forward some of the super trends which were already emerging, some of which will now become a permanent way of life. The use of technology to run our lives on a day-to-day basis was forced on us by necessity, and now it could become the norm.

Where there was reluctance by individuals to use electronic banking, through necessity everyone has moved to self-service banking. The same with goods and services as people had no choice but to use e-commerce as a way of conducting their lives and obtaining life's staples. We also saw that in a lot of discretionary retailing as well. These trends were developing anyway, but the inescapable global experiment triggered by COVID-19 has proved that society can operate in lockdown, and a lot of this is down to technology. As a consequence of being shown another way, there is likely to be a high degree of permanency in these behavioural changes.

Another thing we learnt is that there are businesses that can thrive in such environments. A lot of retailers have realised that they can operate using e-channels for sales, and that they don't need to have such a large bricks-and-mortar footprint. This has accelerated the trend giving retailers an upper-hand in negotiating with landlords, this was not the case ten years ago. The shift from bricks-and-mortar retail is not a fad, it is structural.

Q: Australia has a burgeoning tech sector. How has this gone in the face of COVID-19?

Technology companies have outperformed during COVID-19 on the explosion in work-from-home demand, related entertainment, demand for home-based tech, and more fundamentally, in proving-up online sales and distribution for both essential and discretionary spending. People have increasingly learned to trust tech and online.

Under COVID, we have seen an acceleration in purchasing through online platforms. One beneficiary is Afterpay (ASX:APT), the buy-now-pay-later platform, and Afterpay has grown dramatically, as reflected in its share price.

Demand for data centres has grown dramatically. NextDC (ASX:NXT) is one of the groups that actually experienced upgrades in earnings during COVID, with the level of inquiry and demand growing significantly. Again, we believe the pull-forward of demand is not only structural, it is accelerating.

Appen (ASX:APX) specialises in providing test data for machine learning and artificial intelligence, Altium (ASX:ALU) develops design software and Audinate (ASX:AD8) leads the audio data transformation market. Atlassian (NASDAQ:TEAM) is another example of Australian tech leadership, though it is listed in the US.

These tech companies are familiar to us because we have nurtured many of these, researched them extensively, and invested in them when they were micro-cap and small-cap stocks. When they become bigger companies, we are fully aware of their performance and potential, and these companies now feature in our mid and large cap portfolios.

You can liken these tech leaders to the healthcare sector a few years ago. We have produced some incredibly strong global healthcare companies in Australia, from Ramsay Health Care (ASX:RHC) to Sonic Healthcare (ASX:SHL), ResMed (ASX:RMD), CSL (ASX:CSL) and Cochlear (ASX:COH), these are all Australian-born companies and they are world beaters. The tech sector now seems to be following the same path.

Q: How about toll roads and airports?

Infrastructure assets in the form of toll roads and airports have been hit hard by COVID-19. Toll roads saw traffic almost vanish during the initial lockdowns; however, as restrictions have been eased, traffic has returned. This has affected companies like Transurban (ASX:TCL). There is a view that the traffic volumes on roads will increase post-lockdown as there will be some reluctance to use public transport. I am not sure how long that will last. We have also seen heavy vehicles bounce back strongly.

Airports are a little bit different. Zoom and Skype are far more acceptable now, so there is likely to be less travel, with more interaction in this form. You still can’t take away from the benefits of travel, and being on-the-ground still has its advantages. However, we don’t see airports experiencing such a strong recovery as other transport infrastructure as international travel is likely to be lower, though domestic travel is expected to approach previous levels. Airports like Sydney Airport (ASX:SYD) and Auckland International Airport (ASX:AIA) have hit recent lows and since rebounded somewhat; however, we remain cautious.

Q: How are resources going with COVID-19 and geopolitical tensions?

If you go back to the GFC, it was more about austerity than spending, and it was up to the monetary authorities to do the heavy lifting. This time around, we have seen both monetary and fiscal stimulus applied in concert with plans to bring forward activity and infrastructure projects. This is happening globally as a means of reigniting growth, in China, recently in Australia, and we are likely to see it in other parts of the world.

On the basis of fiscal stimulus and accelerated infrastructure spending, the outlook for resources, and particularly steelmaking resources, is pretty strong. Iron ore, the most important of these for Australia’s terms of trade, is seeing renewed demand as COVID-driven supply constraints shift demand to Australian ore. Companies like diversified miners, BHP (ASX:BHP) and Rio Tinto (ASX:RIO), and specialist iron ore miner, Fortescue Metals (ASX:FMG), are beneficiaries of this strong demand, as are the mining services companies contracted to help deliver this supply to world markets.

Electric vehicles (EVs) is another theme that is looking stronger. During the shutdown, traditional car manufacturers were retooling towards the production of electric vehicles, creating further demand for selective metals. The changing trend towards EVs will see increased demand for copper from companies like OZ Minerals (ASX:OZL), as well as nickel and lithium in the next 12-months.

Q: How are the banks faring?

If you are optimistic about Australian and New Zealand economic recovery, and we are, you have to be comfortable with the banks. The banks are most leveraged to an improving environment. We are seeing that already. Banks were provisioning for an economy with far higher unemployment levels than we have experienced, a deeper negative growth experience than has occurred, and a more elongated recovery than we are seeing at this juncture.

We believe that the depths of the downturn are not going to be anywhere near as bad as initially expected. If this remains the case, it is a fantastic opportunity for investors to reweight back into the banks. We increased our exposure through the COVID sell-down, and we are now the most overweight we have been in banks for a number of years. We think earnings will exceed expectations and bad and doubtful debts may not be as bad as the market has been pricing.

Most commentators were incredibly negative on banks, and most institutions were underweight the banks based on some pretty ordinary and dire forecasts in the market. All of a sudden, the banks have become a pretty attractive proposition, and the market is still underweight, so the setup is for the banks to trade up as we move into the second half of 2020.

Q: How have you been positioning portfolios for the recession and subsequent recovery?

We have been positioning in sectors and stocks that will benefit from the expected recovery. We have increased our exposure to tech, Qantas (ASX:QAN) and Transurban with an eye to the recovery. In healthcare, we like Ramsay Health Care but we have also been increasing our exposure in Sonic and maintaining our position in CSL. We have maintained our overweight position in bulk commodities. We introduced a copper name in OZ Minerals late last year, and added to it during the recent weakness.

We have also been maintaining positions in companies that are showing sustainable earnings growth and dividend payments. The Goodman Group (ASX:GMG) has a sustainable dividend, it is exposed to the new online world through warehousing and logistics, is well capitalised and has high-tech properties that yield significantly better than competitors' assets.

We see healthcare and tech as growth areas. We see banks recovering quite strongly. We are still underweight retail real estate. We selectively increased our weights to some of the high-quality retail names such as JB Hi-Fi and Super Retail Group during the sell-down.

Paul Xiradis is Executive Chairman, Chief Investment Officer, and Head of Equities at [Ausbil Investment Management](). This article is general information and does not consider the circumstances of any investor.

Five principles from the lost decade of value investing

Raewyn Williams

The decade to 30 June 2020 may be remembered as the 'lost decade' for investors who favour a value style of Australian equity investing. Value investing targets companies priced below what their net assets (book values) or other financial fundamentals suggest the companies are worth.

The investment thesis is that markets are efficient and will eventually push the stock price up to fair value ('mean reversion') prompting investors to buy the stock while cheap and sell once fair value is restored. Benjamin Graham established the first principles of value investing in 1928 and – of particular interest to large, fee-constrained institutional investors – academics Fama and French famously identified in 1992 that the value ('high minus low') style factor could be captured in an equity portfolio in a low-cost, rules-based way using quantitative techniques.

Value investing has become a painful experience

Targeting risk premia (outperformance) from style factor risks in this way has come to be known as 'factor investing'. Since the release of the Fama-French factor investing framework, the three stand-out factor performers in the Australian equity market have been momentum, low volatility (low beta or 'safety') and value.

Leading into the last decade, value, with its intuitive thesis and empirical support, seemed to follow the script in Australia. Before fees and taxes, a hypothetical value portfolio of Australian equities (nominal returns) would have grown by 31.9% over the decade to 30 June 2010, easily outstripping a momentum portfolio (17.9% compound growth) or a diversified portfolio spread equally between these two style factors (25.2% compound growth).

But the past decade to 30 June 2020 has proven extremely painful for value investors, and not just in Australia. The performance rankings of these three strategies, in fact, reversed: it has been momentum's decade (72.1% compound growth), with the diversified style portfolio growing 46.3% and value bringing up the (distant) rear at 23.9% compound growth. This ranking has not changed through the coronavirus crisis period (measured from March-June 2020).

Value is known to be a long-cycle play, but a decade (and counting) of waiting for value's expected mean reversion to eventuate has tested the faith of even long-horizon investors. There is even speculation that Warren Buffett, an exponent of value investing, has abandoned the approach.

What should we make of all this, especially during the financial market stress brought on by the coronavirus? Historically, value stocks have not benefited from 'flight to safety' market environments, but they tend to rebound strongly from recessions. So, value's long-awaited recovery can't be ruled out and plenty of institutional money is flowing into value again … but plenty, of course, is not.

A reminder of five basic principles

There are, at least, some principles we can remind ourselves of as we reflect on the experience of value investing over the past two decades.

First, *value investing can require a long time horizon for its thesis to play out*. For large institutional super funds, many stakeholders (trustees, investment committees, product teams) need to commit to this journey and not panic or abandon value's investment thesis during protracted periods of under-performance. A fund can pursue other well-supported equity factor risk premia with shorter payoff cycles (like momentum) if it doesn't have the fortitude to persevere with value investing.

Second, *a good factor investing strategy should not rely on getting the timing right*. Like timing markets in general, factor timing is tricky at best. Over the two decades of our analysis, a value strategy that made a contrarian switch into momentum just before the 'lost decade' of value commenced would have experienced compound growth over the two-decade period of 127%. Sounds good, but a momentum strategy that switched to value at that time (lured by value's stellar record during the 2000s) would have forgone 2/3 of this portfolio value at period end (46% compound growth), making factor timing a high-stakes game.

Third, as our hypothetical 50-50 portfolio's performance shows, *tried-and-true principles of diversification provide a safe course between these portfolio outcome extremes*. If the investor's conviction is in the idea of factor investing in general, then a well-constructed multi-factor 'core' portfolio which does not rely on timing may be the portfolio-of-least-regret.

Fourth, whether we have really just experienced the 'lost decade' of value *depends on the investor's objectives and the role the value portfolio is designed to play*. For example, comparing our hypothetical portfolios over the decade, momentum delivered higher volatility; and, intuitively, value as a style is thought to lower drawdown risk (loss of capital) because stocks are already cheap to begin with. Those who use risk-adjusted return metrics, or custom risk definitions, may have a different view of value entirely.

Fifth, and finally, we counsel investors to *evaluate their factor investing options with an after-tax investing lens*. In 2017 research for funds, we estimated the long-term annual capital gains tax drag on a value factor portfolio to be 84 basis points (0.84%), versus 69 basis points (0.69%) for a momentum factor portfolio. The value of franking credits widens this gap.

The longer it takes for an investment thesis like value investing to play out, the more it makes sense for an investor to 'control what can be controlled' (implementation frictions like taxes and transaction costs) in the meantime. This allows the investor to take the small, steady wins until the big investment bets pay off.

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Is the '4% rule' for retirement broken?

Christine Benz

Retirement researchers have been sounding the alarm about the 4% guideline for a while. They've noted that the combination of very low bond yields and not-inexpensive equity valuations mean that a starting withdrawal of 4%, with that dollar amount adjusted for inflation in each year thereafter, could cause a retiree to prematurely deplete his or her funds over a 25- to 30-year horizon.

The fact that the current pandemic has forced yields lower still - to just 0.7% on the 10-year Australian Government Bonds as of 21 July 2020 - imperils the 4% guideline even further.

In an interview on *The Long View* podcast, recorded in the US in March 2020, retirement researcher Wade Pfau discussed the case against the 4% guideline. He also shared some thoughts on withdrawal strategies that retirees should consider instead.

Pfau is a Professor of Retirement Income at The American College of Financial Services. This excerpt from the interview has been lightly edited. The entire transcript covers other aspects of retirement planning, including long-term care and what Pfau calls "buffer assets".

Christine Benz: Wade, withdrawal rates are an important component of retirement planning. The obvious adjustment to make in the face of a declining market would be to reduce withdrawal rates. In fact, you wrote this week that it's important to understand that the 4% rule does not apply today. Why is the rule broken now?

Pfau: Well, there are a number of factors. People are living longer and the 4% rule ignores taxes, it assumes investors are not paying any fees on their investments, and so forth. But the biggest driver for what I'm talking about right now is the low-interest-rate environment.

Low bond yields mean low bond returns in the future. And there's not really any controversy about that. If interest rates don't change, today's bond yields will be the bond returns. And then, of course, if you're holding bond managed funds, well, if interest rates go up, you're going to have capital losses, which make things even worse. Or vice versa, if interest rates decrease further, you could have capital gains. But effectively, future bond returns are going to be close to today's bond yields. The 4% rule is based on historical data, where we've never seen interest rates this low.

We're also dealing with this high-valuation environment and historically low interest rates, lower than the 4% rule ever had to be tested by. And so, it's not as clear how stocks can come to the rescue of bonds in a diversified portfolio. If you just take historical average data and plug that into some sort of financial planning calculator, which is kind of the naive approach that still gets used today, that will be assuming you're going to have 5% to 6% bond returns in the future. The 4% rule looks like it's going to work 95% of the time.

But if you just lower returns to account for lower interest rates, and because of this idea of sequence-of-returns risk, even if interest rates normalise later to their historical averages, that's kind of too late if you're retiring today. Based on those kinds of projections, you're going to be looking at the 4% rule working more like 60% to 70% of the time. And that's usually not the amount of safety people want.

If you want the kind of safety of at least getting your strategy to work 90% of the time, the lower interest rates are going to push you toward something like 3% being a lot more realistic than 4% as a sustainable strategy in a low-interest-rate environment.

Benz: You mentioned variable spending, Wade, as a way of potentially addressing these conditions. So, a very crude way to do that would be to simply use a fixed-percentage withdrawal and take the same percentage out of a portfolio every year regardless of what the portfolio value is. But that's obviously not ideal from a quality-of-life standpoint. So, let's walk through how one could create a sensible variable withdrawal strategy.

Pfau: What you explained is the opposite end of a spectrum of extremes. The 4% rule is the other extreme. It's 4% of your initial retirement assets, which tells you how much you can spend. And then you just keep spending that same dollar amount every year (adjusted for inflation) and you never adjust based on market performance. There's always going to be a withdrawal rate, but you don't care what it is, you just keep spending the same amount.

Then what you described is the opposite end, where you just spend a fixed percent of what's left every year. So, you're always using the same withdrawal rate every year, but your spending will fluctuate, and it could fluctuate quite dramatically just based on how your portfolio is doing. Those are the two ends of the spectrum.

There's a host of strategies in between that try to develop some sort of compromise between thinking you should make some adjustments to your spending. And that does help manage sequence risk. But you don't necessarily want to adjust your spending too much. In practical terms, just following the required minimum distribution rules to define spending in retirement, that's going to be related to the fixed-percentage strategy, but it actually is pretty closely aligned with what academic research shows is the optimal way to spend beyond that as well.

Different advisers have proposed different types of variable spending strategies. One of my favourites is from Bill Bengen who created the 4% rule initially. But he talked about a 'floor and ceiling' approach, where you spend a fixed percentage of what's left every year but you decide you're going to have a floor that you don't want your spending to fall below a certain dollar amount, and then you have a ceiling where you're not going to let your spending go above a certain dollar amount. So, as long as you're within that range, you just spend a fixed percent, but you apply the floor and the ceiling.

This helps to manage sequence risk by adjusting your spending. That floor might not be all that much less than what the 4% rule logic - always spend the same amount every year no matter what - would have had you spending. So, you have the potential to spend more on average, and even on the downside, you're not really spending all that much less. That's a pretty easy strategy to implement.

Jonathan Guyton developed his decision rules with William Klinger that are a lot harder to implement in practice and do call for occasional 10% cuts to the distribution that are permanent. But that could be another option as well.

Benz: Before we leave required minimum distributions as maybe a benchmark that someone could use, what are the virtues of that. It updates with my age and my portfolio value, and so that is valuable?

Pfau: The academically optimal way to spend is, you're going to adjust your spending every year to reflect your portfolio value and your remaining longevity. As people age, their remaining life expectancy gets shorter. And so, naturally, people can spend a higher percentage of what's left as they age.

The required minimum distribution rules guide that sort of spending. You could play around with making them a little more aggressive if you want to spend a bit more aggressively. But generally speaking, that's what academics are saying: spend an increasing percentage of what's left every year as you age. And that can be the most efficient way to spend down your assets in retirement.

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Hedging for capital preservation

Noel Whittaker

Investing is not easy in these volatile times. The world is still in the grip of COVID-19, and the outcome of the US presidential election is growing more uncertain by the day. Stock markets generally have been doing well, but it seems everybody I know fears that a big crash is just around the corner. Now, it’s a given that forecasting markets is a mug’s game, but there are now investment products available that can be used as a kind of a hedge.

Hedging a stock portfolio against market falls

On New Year’s Day 2020 an investor with $800,000 in blue-chip Australian shares has a premonition that there may be tough times ahead. He knows it’s important to keep at least three years’ planned expenditure readily accessible, so he will never be forced to dump quality assets at a bad time. He does the numbers and decides an extra $100,000 would be useful to keep as a backstop.

For these examples, I will assume his portfolio’s return matches the All Ordinaries Index.

Option One is to withdraw $100,000 and bank it. The interest will be minuscule, but he has the satisfaction of knowing that there is no chance of capital loss, and the money is there when he needs it.

Option Two is to buy some physical gold. In early January, gold was selling for US$1,519 an ounce (A$2,267) so $100,000 would buy him 46 ounces. The Australian dollar was then worth US$0.67.

Option Three is to try one of the relatively new hedging products, such as BetaShares Australian Equities Strong Bear Hedge Fund, (ASX:BBOZ). It’s like an index fund except that it moves inversely to the All Ordinaries Index. And it has an extra twist – it’s designed to do double whatever the index does. So, if the index rises 5%, BBOZ should fall 10%. In early January the shares were trading at $9.69, so our investor bought 10,320 shares for his $100,000.

Let’s look at the next three months. The All Ords was sitting at 6809 in early January, moved up to 7230 on 21 February and then plunged to 4564 on 23 March. The price of gold also fell – it went to US$1,477, but our investor still did well. Because the Australian dollar had depreciated to US$0.58 his gold was worth A$117,100. This is the benefit of owning assets in US dollars if our dollar falls.

Now let’s look at our new friend BBOZ. Because its value is inversely proportional to the index, it hit a high of $20.15 when the market crashed, and then finished the day at $18.99. The original $100,000 had increased to $196,000. He now has some great choices available to him – he could cash in all the BBOZ shares, bank $100,000 to restore his cash reserve, and spend the other $96,000 to restore his portfolio by buying into a market which has tanked.

As I have said repeatedly, every investment has an upside and a downside. If the market continued rising BBOZ would have fallen at double the rate of the All Ords – but the investor would have achieved substantial capital gain, as well as an income stream, on the remaining $700,000 of the portfolio. BBOZ is a form of insurance, and, as we all know, insurance has a cost.

As a sign of its growing popularity and desire to hedge portfolios, BBOZ experienced the third largest fund inflows among the dozens of listed ETFs in Australia in June 2020, with a net $75 million invested. With the market continuing to rise, the stand-alone investment experience has not been good, but as a hedge, it is expected to lose money when the rest of the portfolio is making gains.

Other bear products

There are other products available, with more being developed. Two available now, both listed on local exchanges, have the codes BEAR and BBUS. The first one moves similarly to BBOZ, except its performance up or down matches the All Ords without the extra leverage of BBOZ. BBUS tracks the American market, so it may be a reasonable punt for those who think the US will go through turbulent times as the election in November gets nearer.

In addition, ETFS recently launched the Ultra Short Nasdaq 100 Hedge Fund (SNAS), which as the name implies, gives exposure inversely-related to movements in the NASDAQ technology index. Note also that this is leveraged, up to 275%, so can generate considerable losses if the NASDAQ continues to rise. There is a companion long fund (LNAS) which gives leveraged gains when NASDAQ rises.

Also note that these products generally gain their exposure through index futures, which may not perfectly capture changes in the actual physical index.

These are not products for everybody, but if you have a substantial portfolio now, it may be worthwhile talking to your stockbroker or adviser, to see if they are right for your own situation.

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For more information on bear funds, see this recent BetaShares' white paper:

Bear funds: Some questions answered

'Bear funds' are one of the few ways investors can profit from market falls, but it is important to know how they work and the risks involved, including how they relate to movements in the underlying market. Financial advice may assist understanding. Please note that bear funds can incur losses if the market rises, especially the 'geared' versions, and this article does not address the circumstances of any investor.

Ilan Israelstam says financial advisers mostly use the bear ETFs for hedging in client portfolios. "*We're really talking about partial hedging ... We typically find that clients use these as they would use a so-called 'alternative assets' allocation, where they're really thinking about not wanting to be as exposed to equities – alternatives allocations are typically in the range of 5%–10%, and that's where they would use these products."*

A year coloured by what I have read

Amit Lodha

I love reading. The first book that I remember was a Famous Five mystery novel by Enid Blyton. It was a gift for a long rail journey from my grandmother (the time from Mumbai, India to my home town Jodhpur, Rajasthan was about 23 hours). Since then travelling and reading have been my two constant companions. Over time, I have learnt that for me reading is the most reliable source of serendipity - an essential ingredient to creating your own luck!

In this period of lockdown with no physical travel, I have continued my journeys through revisiting some old companions and picking up some new ones. This note shares some serendipitous experiences which inform my long-term strategic thinking (rather than the near-term tactical viewpoints).

2020 is a year of destiny. While COVID-19 (and Google) has made us all amateur epidemiologists, if we are to navigate the years ahead successfully, I think a few more areas of expertise might be required to answer the questions at hand.

Is the economic glass half full or half empty?

This topic requires us to step away from the high frequency indicators which populate popular commentary and step back to take a wider perspective. Getting lost in books allows that.

Fully Automated Luxury Communism by Aaron Bastani. I came to this book while researching socialism. The rise of Jeremy Corbyn in the UK and Bernie Sanders in the US made this a topic of real importance. Given the current more 'socialist than Corbyn' policies of the Boris Johnson conservatives, the book is worth revisiting. Bastani pushes forward on the arguments made in *Abundance: The Future is Better Than You Think* by Peter Diamandis, imagining a future where a new paradigm has emerged.

New technologies will liberate us from work, providing the opportunity to build a society beyond both capitalism and its alter ego, scarcity. Automation (the replacement of labour with cheap capital), rather than undermining an economy built on full employment, is instead the path to a world of liberty, luxury and happiness for everyone.

The book charts abundance in energy through the move to renewables and food through new methods of farming and protein consumption. Ultimately, he reimagines Karl Marx's philosophy in the form that true sustainable development is only possible if labour's cognitive and physical effort becomes a route to self-development rather than just a means of survival.

For me the **key investment implications** of reading this book were:

1. An appreciation that **cheap energy** is possibly the biggest future growth dividend for emerging markets like China/India. The 18th-19th century industrial revolution and subsequent dominance of the West was powered by fossil fuels. If we are sunsetting one, could we also be sunsetting the other and heralding emerging markets as the best investment for not only this decade but as the start of the Asian century?

2. Greater interest in the thematic of **sustainable food/farming** and the merits behind the vision of the likes of Beyond Meat and Impossible Burger and its ilk and links to climate change.

3. An outside-in perspective that '**my search for pricing power'** works only in a capitalist mindset built on scarcity. However, if money is not scarce any more will our investment process (seeking pricing power) continue to work? For now, the market continues to reward companies who are trying to democratise access to knowledge, information and computational power (one narrative to justify the heady valuations of the high growth software cohort).

4. The second but last chapter of Bastani's 2019 book (Ch.11 Reforging the Capitalist State) makes some interesting points relevant for the long-term intersection of **politics and economics**:

- Contrast between universal basic income (a subject which has been dealt with in great depth by Geoff Crocker in his book *Basic Income and Sovereign Money*) and universal basic service (free services provided to everyone with a progressive taxation system). This is possibly the most pertinent issue as the CARES Act in the US (US$600 per week in every unemployed person's bank account) is a live case study of what the future might look like under this scenario and an area which I think deserves a lot more work. Wartime measures last for much longer than we think.

- Making the point that one of the biggest criticisms of the old Soviet economy was its command and control infrastructure, how is today any different with central banks around the world trying to 'plan everything'? In fact, could this be one justification as to why quasi sovereigns like Apple/Microsoft/Google/LVMH/Nestle/Amazon deserve ever higher valuations as they are exceptions to the rule that everyone requires central bank or government support. Both the debt and equity markets are rewarding them with a lower cost of capital.

- Markets are supposed to serve the economy but the reverse seems to be true currently (at least as apparent from central bank actions which deliver socialism for the rich and market capitalism for the rest. Or the pithy version, profits remain privatised yet losses are nationalised).

- Is GDP the right metric to evaluate successful economic management in a world of deflation? The yardstick may no longer apply in a world where technology has made information free, automation has reduced the pricing power of labour, new energy technologies and use of more renewables, will continue to reduce the marginal cost of food/energy and central banks are now well on their way to making money free!

5. The key unanswered question when a world dramatically different from our own is both inevitable and near at hand is 'in whose interests will it be created?' Technology has moved fast to transform work and improve people's lives, yet we have been slow to create the appropriate social and political institutions to adapt to this new world which has led to deepened inequalities.

Other books for these times

Other books that I have enjoyed reading or revisiting during this time:

a. The Levelling - Michael O'Sullivan - an excellent read on the end of globalisation and what needs to be done to reimagine a new world order (see my note here which discusses some of the investment implications of the China/US spat on investment decision-making)

b. Humankind: A Hopeful History - Rutger Bregman - a well-researched and argued case that deep down, people are decent. The instinct to co-operate rather than compete, trust rather than distrust, has an evolutionary basis and by thinking the worst of others, we bring out the worst in our companies, politics and economics. We can and must do better.

c. Grow the Pie: How Great Companies Deliver Both Purpose and Profit - Alex Edmans - In some sense arguing that companies should target social values as a primary goal and that shareholder returns are a secondary outcome. Our colleague Dhananjay Phadnis has written a detailed piece on his thoughts on the book and case studies relevant for Asia; and our colleague Wen-Wen Lindroth has put out a piece on Sustainable Capitalism with echoes of some thoughts from the book. For me it was a useful read as we try to calibrate how much weight we must put to each factor of the ESG matrix as the matrix also continues to constantly evolve.

d. The Partnership - The Making of Goldman Sachs - Charles D Ellis - The reason to revisit the book was to reread the chapter on Sidney Weinberg and his friendship with Franklin D Roosevelt and Henry Ford II, which helped not only cement the leadership of Goldman Sachs but also tell an interesting story of what wartime corporate leadership may need to look like and how one manages the increasing presence of government in the corporate sector.

e. Justice: What's the Right Thing to Do - Michael J. Sandel - So far policy makers have pretty much succeeded in satisfying everyone. However, it is my view that as every work-from-home parent knows, at some point the candy (or iPad) needs to be taken away from the kid and tantrums (tough choices) lie ahead. This book is about various case studies and the process by which tough choices can be made, while serving the cause of natural justice, in a multi-layered problem. With the rise of ESG and as morality (and religious beliefs) now move from private matters to public debate and we sit in judgement of what is happening around us, this is a good refresher of the process that one must follow to appreciate both sides of the coin.

f. Alchemy: The Surprising Power of Ideas That Don't Make Sense - Rory Sutherland. Rory is the vice chairman of Ogilvy in the UK (it's a nice vague title that has allowed him to run a behavioural sciences unit in Ogilvy). I came to this book due to my interest in consumer behaviour and the realisation of how difficult it is to anticipate let alone forecast. Rory's central thesis that conventional logic leads to conventional outcomes is as applicable in marketing as it is in investing. Two of my favourite quotes from the book:
- "*A change of perspective is worth 80 IQ points*" - Alan Kay
- "*It doesn't pay to be logical if everyone else is being logical*" - Rory Sutherland

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