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Editorial

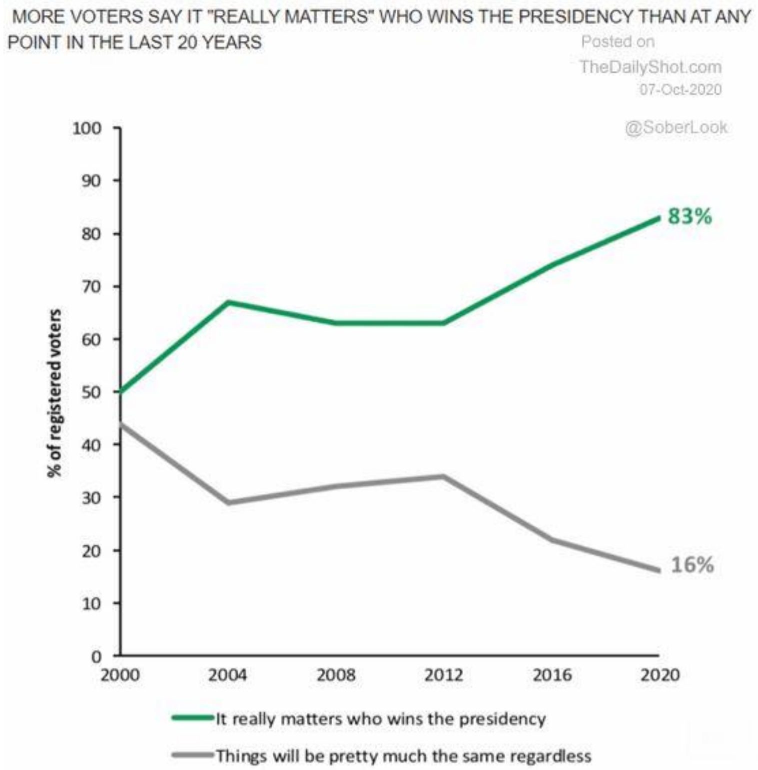
When I was responsible for alliances at **Colonial First State**, in 2007 we introduced **Al Gore's Generation Investment Management** to the Australian retail market (and it has performed well since under the guidance of Co-Chief Investment Officer, **Mark Ferguson**, son of **Sir Alex**). On a couple of occasions, I hosted the 45th Vice President of the US to dinners with investors and advisers, and he was always engaging and informative. His care for the environment was genuine, and the world would have become a different place if the US Supreme Court had ruled in his favour to become President in December 2000 instead of **George W Bush**.

One time, I asked Gore about political funding and its implications. He said when he first went into politics, he raised US$70,000 of his own money and from friends and family, but if he wanted to run for the same position again, he would need at least US$100 million. And that was 13 years ago.

To an Australian, the numbers spent on political advertising in the US are unbelievable. **Joe Biden** will spend twice as much as **Donald Trump** by election day, the combined total reaching an estimated US$2.8 billion just on TV advertising. **Facebook** produces an ad tracker which shows in Texas alone, each spends around US$200,000 a week on the social media site.

There are 12,000 registered lobbyists in Washington, and promises of money and favours are traded every day. That's the democratic system.

Our local news has been dominated by shady deals with property developers, cash for visas, sports rorts, overpriced airport land, questionable defence contracts and former ministers taking outside jobs relating to their prior portfolios. But we are babes in the wood compared with the influence billions of dollars buys in the US. Al Gore told me he would never stand for office again.



With non-compulsory voting in the US, the challenge is to convince people to make the effort, although this time, there are already massive pre-polls and data showing more people than ever care. This time it really matters.

Back to all things investing and our stellar line up ...

Kate Howitt has been voted one of the leading female fund managers in the world, and she reveals the stocks she likes, unique insights into how the investing world has changed in 2020, plus a great tip for inexperienced investors.

In this edited extract, **Hamish Douglass** answers client questions posed by **Frank Casarotti**, including how **Magellan** still plans to deliver on its 9% aspiration over time, and why unlimited government debt is akin to believing in the tooth fairy.

Roger Montgomery rounds out this fund manager trio with a study of what **Warren Buffett** is probably thinking about technology, and the search for sustainable earnings over a decade, not near-term popularity.

The leading futurist **Phil Ruthven** gives some big picture analysis and charts on Australia's debt in a global context, and he asks if we can afford it and what are the future consequences.

Continuing this bumper edition, **Lex Hall** delves into the Morningstar stock screener to find 18 Australian companies rated cheap relative to their estimated value. A great selection for a watch list.

Then a highly-informative article by actuary **Tony Dillon**, who answers a question many people ask: why don't more fundies use options to protect the downside on their share portfolios? It's easy enough in theory but what does it cost?

Finally, **Grant Berry** says that listed property has recovered better than expected and many sectors offer the yields that have become increasingly scarce elsewhere.

This week's White Paper from **Capital Group** is a guide to market recoveries, and the benefits of staying invested for the long term, including three mistakes that investors should avoid.

Kate Howitt: investing lessons and avoiding the PIPO trade

Graham Hand

Kate Howitt is Portfolio Manager for the Fidelity Australian Opportunities Fund which she has managed since its inception in 2012. She was included in CNBC's list of the world's Top 20 female portfolio managers across equities and bonds based on fund performance and she was with Fidelity when it opened its Australian office in 2004.

GH: Do you feel the economic stimulus packages in Australia have done enough to carry the market through to whenever a vaccine arrives?

KH: We have the benefit of good economic management in the past, which means we went into this with a clean sovereign balance sheet and a close-to-balanced budget. It gave us more room to maneuver than a lot of other countries. The Government has grasped the enormity of the challenge and thrown dogma out the window quickly with some effective policy responses. Globally, we've seen enormous liquidity injections and strong fiscal measures and now pump priming, but it wouldn't be surprising to see some wobbly patches as we move from one stimulus level to another, and not all jobs and businesses will survive.

GH: And allowing companies to continue trading while they are insolvent has delayed an inevitable wave of company liquidations which will hit the news in coming months.

KH: Absolutely, a reality check. And one of the challenges is to avoid creating a class of zombie companies. There needs to a constant creative destruction or winnowing out of weaker companies to leave sunshine for stronger companies to thrive.

GH: Your Australian Opportunities Fund invests across the market including small to mid-cap stocks. Do you feel the stock market has missed a sector or companies that you've identified?

KH: We've seen many COVID winners and losers. Some companies have benefited from people working from home but we're seeing a line of sight back to normalisation. We think there's upside in homebuilding in Australia, such as Bluescope (ASX:BLS) with Colorbond, but also a recovery of industrial activity in the US, particularly the auto sector. In smaller companies, we like the Australian biotech Starpharma (ASX:SPL). It has a range of therapeutic molecules, mostly targeted at the oncology space, but they've got an antiviral that shows great promise with regulatory approval already in major markets. Until a vaccine is thoroughly worked through and even beyond that, there will be gaps and a desire for a simple, low intervention nasal spray as a convenient therapeutic. And when you look at the market value of Starpharma relative to other companies around the world that have COVID-19 therapeutics, it's not being priced in at all.

GH: Where are you in the 'value versus growth' debate?

KH: Well, broadly, there are two ways to make money with stocks. One is to find stocks that are cheap now relative to the value today, and the other is to own stocks that are long-term winners. They may be fairly valued today but they will continue to grow through time.

Both are valid ways to make money but the latter that has really outperformed this year. Software companies and online retailers started expensive and then got much more expensive. That can be characterised as 'value versus growth' and growth has delivered for many years now. It's one of the big questions for markets: when will it make sense to buy those cheap companies with attractive valuations when such investing has not paid off for a while?

GH: So that leads to whether you see specific stocks and sectors the market is too optimistic about.

KH: There's a huge amount of optimism baked into the Buy Now Pay Later space and into the retailers and they've been clear beneficiaries of the lockdown. But it's hard to untangle how much of that is a structural shift caused by COVID versus how much is a short-term boost. When conditions normalise, will they lose some of those gains? There's not much margin of safety in those valuations.

GH: Where stocks run on their own price rise success and they lose connection with the fundamentals.

KH: Yes. The fascinating phenomenon is the shift in market participants. A couple of decades ago, markets were comprised of institutions and mum and dad investors. Both were working on price versus value. So whether a professional or not, investors would buy a stock based on a view of what it was worth, and its value over some time horizon. And that was pretty foundational.

But now the majority of investments are index flows or ETF flows trading on some other proxy of outperformance. They are agnostic on valuation, they don't even ask the question on what is fair value of a stock. They just ask the question, what's its weight in the index. Or does it fit into my ETF parameters or does it tick some other quantitative box like momentum.

Markets used to work on the wisdom of crowds, which was a lot of non-correlated guesses of how many lollies are in the lolly jar. The old saying was that in the short term, the market is a voting machine but in the long term, it's a weighing machine. Now, there's a lot voting activity and not nearly as much weighing.

GH: That's a great point, that we don't simply have a cyclical change but a new structure in the way the market works. Can anything break this pattern?

KH: It's one of the drivers of this extended bifurcation between growth and value. The things that do well draw even more buying support so inefficiencies and anomalies persist for longer than they would have in the past.

GH: What have been your best performers in 2020 and why do you remain keen on them?

KH: Our Top Three contributors over the past 12 months were Evolution Mining (ASX:EVN), Mineral Resources (ASX:MIN) and CSL (ASX:CSL). Evolution is our top pick in the gold space, based on both its own merits and the gold price. They've made a recent acquisition in Canada which shows a lot of potential on a medium- to long-term view. Management are good capital allocators in a sector where it's easy to destroy value by buying other gold companies when the gold price is high.

Mineral Resources has performed well, particularly with its exposure to the iron ore price. It also has lithium assets which the market has been attributing no value to. And CSL is a large stock but still capable of delivering strong growth although there might be some hiccups over the next 12 months from plasma collection.

In all three cases, quality management is a key part of investment thesis. We are believers in the Warren Buffett view on backing the horse not the jockey, so we are looking for companies that have strong competitive advantages. But where we can also get a good jockey, we like that a lot too.

GH: And at the other extreme, what is your biggest portfolio disappointment?

KH: Treasury Wine Estates (TWE). We had done well out of it for a while, but it's had a big tumble on the back of management changes and analyst views on its export markets. We like the business for the strength of its brands, notably Penfolds, and the management team has been reorienting the business towards cellaring for longer to make more luxury wines. The cost is keeping the inventory on the books for a couple of years, but we like that re investment. It will come through in earnings in future years.

GH: We have all read about the 'Robinhood' retail investors, particularly in the US, but do you see the same influences in the Australian market?

KH: We always had a strong retail component but it was mostly centered on fully franked dividend stocks, which made a lot of sense. But there is now a lot of trading in a new cohort of stocks, such as Afterpay (ASX:APT), Zip (ASX:Z1P) and Mesoblast (ASX:MSB). In the US in the 1960s, retail was about 40% of stock trading flows but it had fallen to 10% by 2010 and now it's back to about 20%.

One part of me says this is great, this is capitalism in action, the benefits of Wall Street being made more available to Main Street. But then part of me thinks that this is just people who are unable to engage in sports betting and going to the casinos and having a flutter, and they are bringing that mentality into the stock market. This type of activity does tend to be a hallmark of a late cycle. So I'm unsure whether to applaud this as grassroots capitalism or take it as a sign of a speculative top.

GH: And when you read social media posts on TikTok and Reddit and even Twitter, there's a lot of chat about how easy it is to make money in stocks. You've spoken before about TINA and YOLO. What will it take to shake these new participants from the market?

KH: So let's break down those acronyms. TINA is 'There Is No Alternative'. It's more an institutional phenomenon, that since the GFC and increasingly in 2020, monetary policy has made the largest securitised asset class in the world, ie the bond market, less attractive. Bonds now offer high volatility and low returns. So where else does money go but the next largest securitised asset class, stocks? I call these investors 'bond market refugees'. Their natural home is bonds but they can't stay there anymore. They can't move quickly back because if you've called the top of the bond market, it's the end of a 30+ year cycle. It's not something that plays out in a month or two. It may give strong support for equity markets globally for years. They are not buying stocks because they're cheap but because of the relatively-better prospects than bonds.

Contrast that with YOLO, which is 'You Only Live Once', which is a tag some retail punters put on their trades. If you're a YOLO day trader, you're not buying stocks because you've done your DCF valuation. You're buying because it's a thrill, to have something to do in an otherwise really boring lockdown.

So TINA has legs and can go on for longer whereas YOLO probably runs out either when people either exhaust their stimulus money or sports betting ramps back up or people go out and do more interesting things. I think it will fizzle out in a nearer term.

GH: What advice do you offer to less experienced investors?

KH: There's the predictable answer that they should find a quality active manager, as we have hundreds of analysts whose job it is to understand stocks and work really hard on a client's behalf. But for those people who enjoy investing for themselves, it's good to go through the mental exercise of asking if markets fell 30% from here, would I be a forced seller? If so, sell some now and put some cash on the sidelines. It's much better when markets fall to scoop up bargains rather than sitting there feeling terrible because you're a seller at knockdown prices. Position yourself to take advantage of volatility rather than being hurt by volatility. It's a foundational part of managing a portfolio.

GH: And we've all seen investors who sell after the market falls and buy after the market rises and end up with the worst result of buying high and selling low.

KH: Yes, my head trader at Fidelity constantly warns against the PIPO trade, which is 'Panic In, Panic Out'. People have evolved to PIPO and it's hard to resist and make well-reasoned investment decisions.

Kate Howitt is Portfolio Manager for the Fidelity Australian Opportunities Fund. Fidelity International is a sponsor of Firstlinks. This article is intended as general information only and does not consider the circumstances of any investor.

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Hamish Douglass on what really matters

Hamish Douglass, with Frank Casarotti

On 13 October 2020, Hamish Douglass (Co-Founder, Chairman and Chief Investment Officer of Magellan Asset Management) held a webinar with Frank Casarotti (General Manager, Distribution at Magellan) called 'What Really Matters'. The questions were submitted by attendees and these are edited highlights.

FC: Why is there such a disconnect between the world economy and the share market?

HD: I often get this question. You have to remember that sharemarkets forecast the future. They are trying to discount all the cash flows of a business from now to Judgement Day to figure out what it's worth. It's factoring in what's happening in the next 12 months but also the next two years and five years and 20 years into the future. When you look at the economy, it's really a very static picture. It's telling you what's happening today. We could have unemployment or credit losses but that's not telling you what the unemployment rates will be in five years into the future.

So you often get this disconnect. You ask yourself at any point in time whether the market is being irrational. There's so much uncertainty at the moment but the market has had a very strong rally, close to its all-time high. Is that completely irrational? It's reflecting a number of things, such as very low interest rates, and the lower interest rates are, the higher company valuations can be because the discounted future cash flows are higher in a low interest rate environment. We've seen an incredible amount of fiscal stimulus and monetary support, and there's a view in markets that with all these trials, a vaccine will be found in 2021.

FC: On the holdings in your portfolio, how comfortable are you on the valuations?

HD: Well, we wouldn't be holding things if we weren't comfortable with valuations. We sold Apple recently because we think it went past our assessment of fair value. Obviously, the market disagrees with us, but we think we're disciplined on valuation. It reflects our view on where interest rates are heading which justifies higher valuations than may have been the case five years ago, although some stocks are more fully valued than others.

FC: What's your most profound observation on the markets over the last 12 months?

HD: I don't think I have many profound observations, but you should never be surprised by what actually happens, or how markets react. You should expect the unexpected. Events like this virus have happened in the past and they're going to happen in the future, although the scale of the economic damage was unexpected. I don't think any of us envisaged the willingness of governments to spend 10 to 20% of annual economic output to manage the downturn. There's almost been an income surplus from the fiscal expenditure. But we want to build resilient portfolios for long-term investors and expect the unexpected.

FC: Does the rising debt matter if interest rates remain low for a lot longer?

HD: It looks like governments don't think that it matters, but taken to extreme, of course it matters. Our own government that was so opposed to debt and deficits is taking on extraordinary amounts of debt. And the argument is, there's no interest cost for this because interest rates are so low. It's almost free. But if we take this to the extreme, why don't we just get rid of all taxation, and governments just borrow the money. Of course, that isn't sustainable.

This even has a name, Modern Monetary Theory. There will be a day of reckoning. Just because interest rates are super low today, you cannot assume they will always be low. And if you believe debt is free and debt has no consequences, you might as well believe in the tooth fairy. One day inflation will come back and one day interest rates will have to increase.

But this period could last for a very long period of time. And what worries me is the longer this goes on, more and more politicians may start believing in the tooth fairy because they have relatively short election cycles.

What are the restraints on them to spend the money today and believe it's a free lunch? I hope there are some rational voices at the table. I think it's been prudent for governments to be aggressive in their in their response in the last six months, but future generations will have a lot to bear. I hope this trend does not get too much momentum.

FC: What are the consequences of this lower interest rate and lower growth environment?

HD: Income and profitability and equity returns will grow more slowly in aggregate and that's going to be a very difficult environment for investors to navigate. They can't simply put their money in the bank, which means they need to be very selective to find reliable growth.

FC: What's your medium-term outlook for the FANGs versus the BATs (Baidu, Alibaba and Tencent).

HD: It's an interesting way to frame the question but I don't regard this as one versus the other. They are subject to different risks. Many of these platforms are highly advantaged businesses and most (except Baidu) have the most powerful business models we've literally seen in the last 100 years. You probably need to go back to the railroad barons 100 years ago. There are very strong network effects in place and they're light in terms of the capital usage, outside of Amazon. I call this 'capitalism without capital', it is truly extraordinary. The FANGS are global plays, ex-China, with ecommerce, digital advertising, cloud computing and entertainment. The big Chinese tech platforms are even broader than the FANGS, including gaming, videos and music. They're into payments, financial disintermediation and local services like delivery.

But all these companies will attract the attention of regulators, so the real questions are, what are the risks? And what are they worth? Yes, we want to buy them when we think they're priced at less than we think they're worth, taking the risks into account. All of them are extraordinary in their own ways.

FC: Does Magellan's long-term thesis of 9% returns still hold despite the pandemic?

HD: This is a really good question. Overall market returns have been good in the last decade or two because of falling interest rates. As Warren Buffett says, interest rates are the gravity of markets. World profitability is probably not going to grow at 9% per annum and we are probably in a low growth world for the next decade. So equity returns in aggregate will be materially below 9% per annum. But we're running a concentrated portfolio with unique sources of growth, and we're not going to lower the bar because it's harder. There's no guarantees that we will achieve 9%, and we will be judged over a full investment cycle of seven years.

FC: Where do self-funded retirees find income when interest rates are so low?

HD: It's a tough one. We are planning to release a product that will answer part of this question, but people will have to take equity risk. So we're trying to mitigate that risk in the product. But I don't have a single solution. I'd be careful about just reaching for income and going down the risk spectrum.

FC: Do you have any advice for younger advisers who are fairly new to the industry and navigating this pandemic early in their careers?

HD: Well, expect the unexpected. If you're an adviser or an investor, stay the course, investing is a long-term business, not determined over three to six months. Find the right businesses and the investments that can compound returns over a long period of time. If you find good businesses, you can largely ignore the short-term issues such as in the last six months. I know it doesn't seem exciting for people who want to trade in and out, but great wealth is built out of compounding.

My best advice is to understand the power of compound interest. As a young person, you have a major advantage over the vast majority of people on this call. You have the advantage of age, and time is super valuable. In this game, as Benjamin Franklin famously said, money makes money, and the money that money makes, makes more money. And that's what investing is all about.

Hamish Douglass is Co-Founder, Chairman and Chief Investment Officer of [Magellan Asset Management](), a sponsor of Firstlinks. This article is for general information only and does not consider the circumstances of any investor.

The full webinar can be viewed here. For more articles and papers from Magellan, please click here.

Buffett and his warning about 'virtually certain' earnings

Roger Montgomery

When Warren Buffett was asked to distill the essence of investing success, he offered the following:

"Your goal as an investor should simply be to purchase, at a rational price, a part interest in an easily-understandable business whose earnings are virtually certain to be materially higher five, 10 and 20 years from now. Over time, you will find only a few companies that meet these standards – so when you see one that qualifies, you should buy a meaningful amount of stock. You must also resist the temptation to stray from your guidelines: If you aren't willing to own a stock for ten years, don't even think about owning it for ten minutes. Put together a portfolio of companies whose aggregate earnings march upward over the years, and so also will the portfolio's market value."

Quality is low debt and high rates of return

I am wedded to a relatively strict idea about what a quality business is. A company should sustainably produce high returns on equity with little or no debt. Why? Because it suggests the company has a competitive advantage.

You see, when companies generate high rates of return, they attract competition. The easiest and most mindless way for new entrants to compete is to offer cheaper prices, which of course reduces gross margins, putting pressure on net margins and therefore returns on equity. If a company can generate a high rate of return on equity sustainably it has been able to fend of the competitors or sufficient barriers to entry exist to block or slow their entrance in the first place.

A high level of debt relative to equity can artificially boost the returns on equity but of course debt carries risk. A company generating high rates of return on equity with little or no debt has all the attractive qualities without the risk. Of course, there may be a point in time where debt needs to be held but when very high returns are being generated after the interest is paid, the debt usually isn't held for long. By definition therefore, a quality business has a competitive advantage so powerful it doesn't need to carry debt.

It wasn't that Buffett disliked technology

For years Buffett and Munger ran the line that they didn't like technology and many commentators proffered the explanation they didn't understand technology. I have never believed that. Two Mensa geniuses with a lifetime of business experience and photographic memories can pretty much back solve whatever they put their minds to.

Instead the issue with technology is the fast-paced nature of change, which makes the formation of a view about the future competitive landscape almost impossible with any certainty. If one cannot establish whether a business will be the long-term winner in a competitive environment it is impossible to say the business is 'easily understandable'' nor whether its earnings are 'virtually certain to be materially higher five, 10 and 20 years from now".

That is fundamentally why Berkshire Hathaway has hitherto been devoted to businesses with predictable outlooks.

More recently, Berkshire invested in technology and is reported to own 245 million Apple shares, representing a stake of just under 6% in Apple worth US$114 billion at current market prices. It represents almost a quarter of Berkshire's own market capitalisation of US$500 billion.

The position in Apple does not suggest Buffett has strayed from his oft-touted principles of investing. On the contrary, Apple along with its FAAMG peers (Facebook, Apple, Amazon, Microsoft and Google) harbour the very qualities that Buffett has insisted should characterize a portfolio.

Not only are the earnings of these companies growing at a rapid pace but as they grow, they are becoming more profitable. Returns on equity have increased for each of the five over the last four or five years.

The enduring appeal of the FAAMGs

I looked at the returns on equity for each of the FAAMGs for the last five years and discovered something universal; as these companies grew, they became more profitable.

In 2016, for example, Microsoft was earning US$20 billion on US$76 billion of equity – a return on equity of 27%. In 2020, Microsoft's equity was a little more than 50% higher at US$110 billion but the company earned more than double its 2016 profits at US$44 billion. It therefore recorded a return on equity of 40%. Improvements in profitability, as measured by return on equity, similarly improved for the remaining four of the FAAMGs.

And in addition to benefitting from the network effect and flywheel competitive advantages, they have become monopolies in which inheres the most valuable of all competitive advantages. They have the ability to raise prices without a detrimental impact to unit sales volume. In a world of declining real rates of return, such pricing power and growth is scarce and highly prized by investors.

As an aside, in his book *Monopolized: Life in the Age of Corporate Power* author, journalist and Executive Editor of one of the most important political magazines today, the *American Prospect,* Dave Dayen notes that practically everything we buy, everywhere we shop, and every service we secure comes from a heavily concentrated market.

In a recent interview about monopoly power in the US, Dayen comments on Buffett:

"This is a guy whose investments philosophy is literally that of a monopolist. I mean, he invented this sort of term, the economic 'moat', that if you build a moat around your business, then it's going to be successful. I mean, this is the language of building monopoly power. He not only looks for monopolies in the businesses he invests in, but he takes it to heart in the business that he's created, Berkshire Hathaway. Berkshire Hathaway owns something like 70 or 80 or 90 companies and they have large market shares in all sorts of areas of the economy", adding, "It's kind of like an old school conglomerate from the sixties and seventies, but there are certain facets of it, where he's clearly trying to corner a market. Buffett's initial businesses that he actually outright purchased were newspapers. It started with the Buffalo News in Buffalo, New York. And he used anti-competitive practices to put the competition, his rival newspaper, out of business. That was literally his MO there."

Elements of monopoly and anti-competitive behaviour

The FAAMG stocks demonstrate at least some of the hallmarks of monopoly power and some of these companies, as well as their peers and counterparts, engage in anti-competitive behaviour.

Most recently, I read Spotify's developer agreement. Yep, Fun! In Section IV *Restrictions,* Part 1 *General Restrictions*, clause 1.f. reads:

"Do not use the Spotify Platform, Spotify Service or Spotify Content in any manner to compete with Spotify or to build products or services that compete with, or that replicates or attempts to replace an essential user experience of the Spotify Service, Spotify Content or any other Spotify product or service without our prior written permission."

Many would argue this is blatantly anti-competitive. Another business, therefore, might not be able to build a tool that transfers a user's list of songs from Spotify to another service provider even if the consumer and the artists who produced the songs might benefit from the transfer.

While the presence of such behaviour puts these companies in the sights of future anti-trust action and therefore generates new risks for investors (we'll hear more about that in coming years) the popularity of their shares with investors has spilled over to other technology companies that have not demonstrated the ability to generate sustainable high returns on equity.

Not all technology companies have 'virtually certain'

Indeed, in the next tier of technology companies - and those companies in the many tiers below that – they don't generate a profit and some don't even generate revenue.

What is happening here is that low interest rates have made it appear safe to pursue growth at the expense of all else. The popularity of the strategy has led to a self-fulfilling and virtuous spiral where success reinforces the validity of the approach. Consequently, investors are pursuing growth irrespective of whether the company displays the quality characteristics required to sustainably generate highly profitable growth. The absence of profit or even revenue is not a hurdle to investment success and therefore not relevant.

Take for example, Hyliion, a Texas-based truck electrification business, founded by 28-year-old Thomas Healy. While the company is not expected to generate revenue from supplying aftermarket hybrid and electric thrust systems for long-haul trucks until at least 2022, it hasn't stopped a merger with cash-box Special Purpose Acquisition Company (SPAC), Tortoise Acquisition Corp, effectively valuing Hyliion at US$7 billion. There are many other examples.

While investors are happy to pay top dollar for leading online companies, Buffett's lesson about quality and certainty of future growth should not be forgotten. Revenues may be growing but you want to own a business whose earnings are virtually certain to be materially higher in five, 10 or 20 years from now.

Note the imperative 'virtually certain' about earnings or profits. One can only be 'virtually certain' if in addition to growth the company has a sustainable competitive advantage. In the absence of high barriers to entry, defendable intellectual property or monopoly conditions, the sustainability of highly profitable growth is in question.

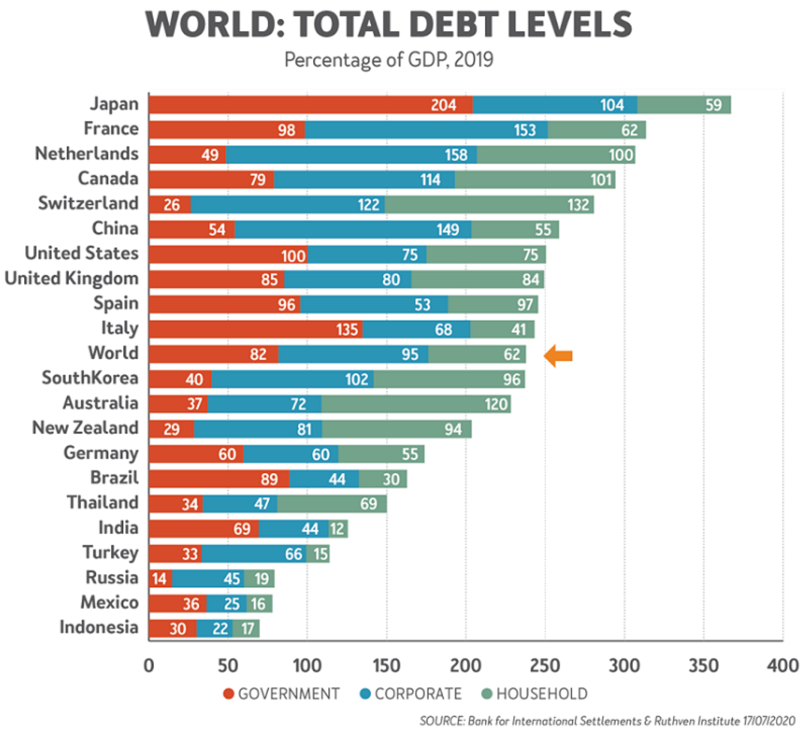
Roger Montgomery is Chairman and Chief Investment Officer at Montgomery Investment Management. This article is for general information only and does not consider the circumstances of any individual.

Are debt and its servicing cost serious worries?

Phil Ruthven AO

The world is swimming in debt, as high as it had been before the GFC in 2008, with government debt-bingeing establishing all-time records due to the mishandling of COVID-19 health-wise.

The world is heading for a debt level of 300% of GDP or more, Japan is nudging 400%, and four other countries are heading over 300% in 2020. Among the big 10 economies, our nearest neighbour - Indonesia - is the least indebted with less than 100% of GDP.



Australia joins the debt party

Until March 2020, Australia was relatively well-behaved, with a total debt of less than 250% of GDP. Our government debt, at 37% of GDP in 2019, was only bested in the developed world by Switzerland at 26%. The main risk was our household debt (mostly mortgage debt) at 120% of GDP.

All that changed with the announcement in the first half of 2020 that we would be spending $360 billion to fight COVID-19, despite there being less deaths from the pandemic than normal respiratory deaths (mainly the over-70s age group) in previous years.

On the Budget night, the cheque book came out again. Now we have prospects of a government debt of $1.7 trillion by end 2024, or over 80% of GDP. That would put Australia's total debt closer to the 275% of GDP mark.

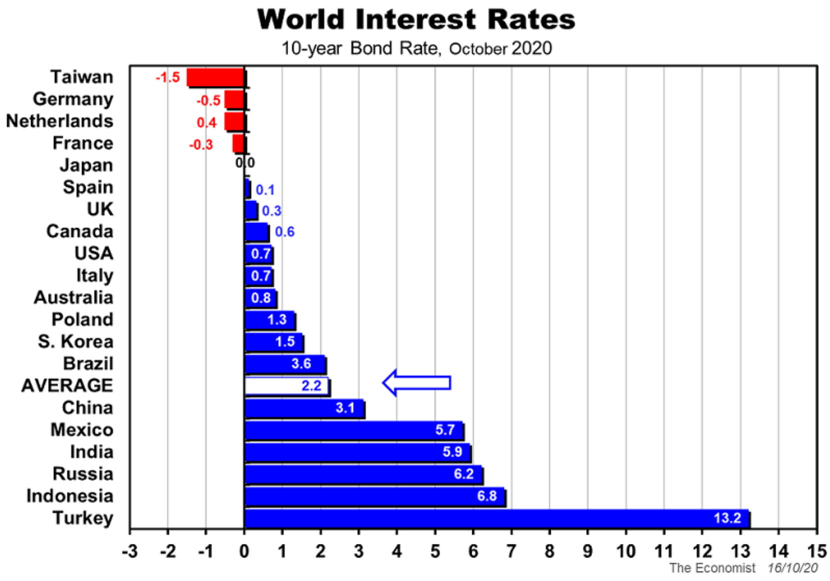
Is this serious? Yes, but not debilitating.

The economy will almost surely suffer more from the shutdowns, and general deprivation of commerce and liberty, including the controversial border closure of 2020. Around 1-in-7 businesses shut down in good years, or some 280,000 businesses of the total 2.3 million. That share may rise to 1-in-5 or 6 for a year or two.

Debt versus servicing costs

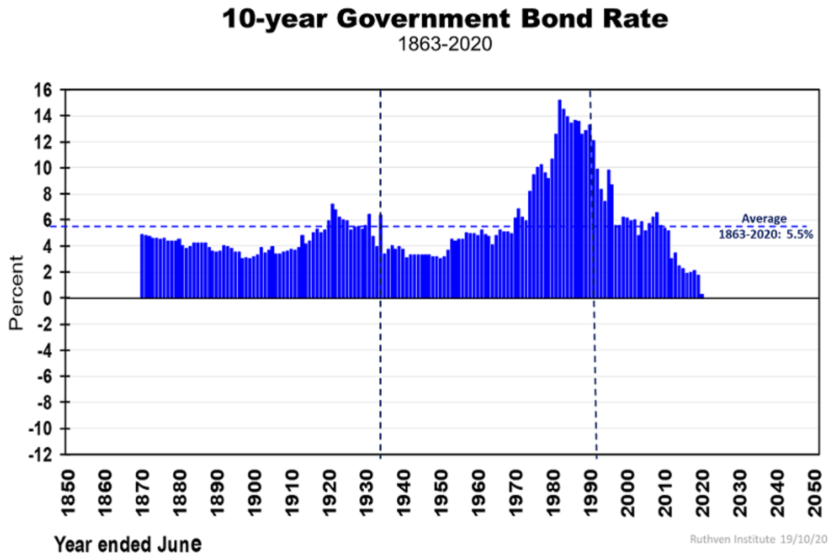
Debt is always less of an issue than its servicing cost be it as a share of government revenues, business revenues or household disposable incomes.

So, interest rates are just as important as the debt levels. The top chart provides perspective on government debt servicing costs via the 10-year government bond rates across various countries.



Australia's bond rate means that, even if it climbed back to 2% by 2024, it would only account for 5% or less of all government revenue (taxes and other income).

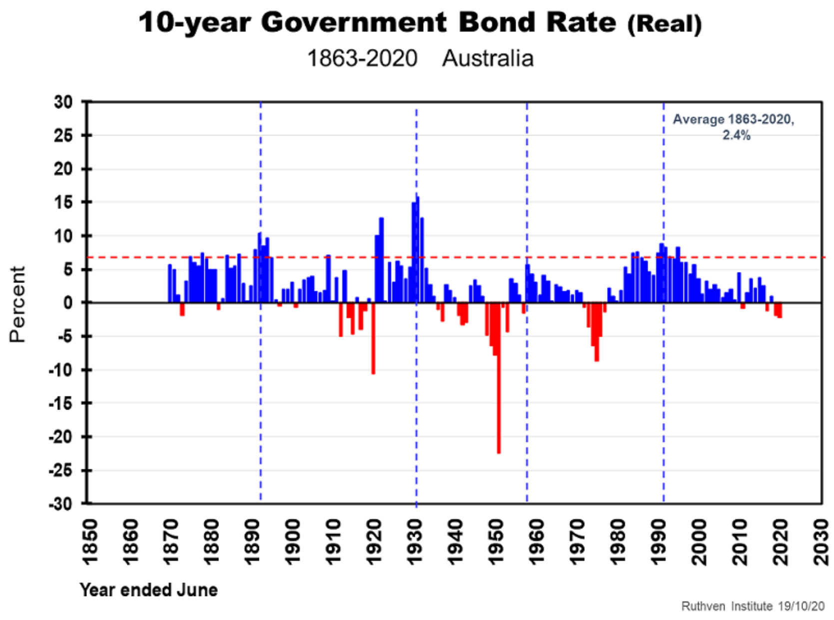
The middle chart shows the long history of 10-year bond interest rates, which have averaged 5.5% over the past 150 years, but are now less than 1% and seemingly at a record low.



But when converted to real interest rates, by deducting inflation, we are far from a record low. Indeed, there have been at least 15 years when the real interest rates were lower than in 2020.

What all this means is that the debt and its servicing is probably less of a problem than repairing and re-building the wrecked economy, especially in Victoria.

We can service the debt. But of course, if and when bond rates go back to 5% (a long way off it would seem), governments will pray for higher inflation for several years to dilute the debt mountain. That's what happened in the 1950s, when inflation (including one year at 25.25% in 1953) diluted the WWII national debt of 110% of GDP to a very manageable share of GDP (see bottom chart).



More serious than debt

The more serious problems for the next 5-10 years are:

- How to get the economy back on its feet and restore our standard of living (GDP/capita) back to the March 2020 level before 2025.
- What to do differently with the next pandemic, bound to arrive well before the end of this decade.

- How to restore our international trade in the huge and fast-growing Asia region with the problems and tensions there, from COVID-19 (closed borders), trade wars and hegemony.

We need better long-term vision, innovation, reforms (I have covered the subjects of parliamentary, labour market, taxation and commerce reform previously), statesmanship and management than we have had over the past 10-15 years or more. And that goes for corporate Australia too: we are lagging well behind world best practice (WBP) innovation, performance and profitability.

That said, who of us would prefer to live elsewhere in this extraordinary and turbulent world of the third decade of this 21st century?

Phil Ruthven AO is Founder of the Ruthven Institute, Founder of IBISWorld and widely recognised as Australia's leading futurist.

18 Aussie names for your watchlist

Lex Hall

(This article was available to Morningstar subscribers on 14 October 2020 and some prices have changed in the week since).

Takeover target Link Administration, funeral home operator InvoCare and Australian Pharmaceutical Industries head a list of stocks trading at discounts of up to 30% and in most cases a competitive edge of a decade.

Eighteen companies under Morningstar coverage are trading at discounts of between 10 and 30%, with mostly 'medium' uncertainty ratings, a Morningstar Premium stock screener reveals.

More than half the names on the list have narrow moats, which implies a ten-year competitive advantage. Two names have wide moats—or 20-year competitive advantage: InvoCare and pallet maker Brambles.

Left, is a snapshot of some of the companies mentioned. As always, we invite you to click on the links to get a fuller picture of Morningstar analysts' take on the pros and cons of each.

18 undervalued Australian equities under coverage

Name	Analyst Rating	Fair Value Uncertainty	Economic Moat	Last Close $	Fair Value Estimate $	Price/FV
Link Admin LNK	★★★★★	Medium	Narrow	4.99	7.70	0.65
InvoCare IVC	★★★★★	Medium	Wide	10.10	15.30	0.66
Aust. Pharma. API	★★★★★	Low	None	1.03	1.50	0.68
Telstra TLS	★★★★	Medium	Narrow	2.78	3.80	0.73
NIB Holdings NHF	★★★★	Medium	Narrow	4.24	5.60	0.76
AGL Energy AGL	★★★★	Medium	Narrow	13.35	17.50	0.76
Perpetual PPT	★★★★	Medium	Narrow	30.20	38.50	0.78
Computershare CPU	★★★★	Medium	Narrow	13.34	17.00	0.78
Charter Hall Social Infra. REIT CQE	★★★★	Medium	None	2.83	3.60	0.79
Sigma H'care SIG	★★★★	Medium	None	0.58	0.72	0.81
Pendal Group PDL	★★★★	Medium	Narrow	6.08	7.20	0.84
Orora ORA	★★★★	Medium	None	2.52	2.90	0.87
Spark Infra. SKI	★★★★	Medium	None	2.09	2.40	0.87
Brambles BXB	★★★★	Medium	Wide	10.62	12.00	0.89
Medibank MPL	★★★★	Medium	Narrow	2.58	2.90	0.89
GPT Group GPT	★★★★	Medium	None	4.10	4.60	0.89
Platinum PTM	★★★★	Medium	Narrow	3.26	3.60	0.91
IRESS IRE	★★★★	Medium	Narrow	10.09	11.00	0.92

Source: Morningstar Premium. Data as at 3pm, 14 October 2020.

Most discounted

Link Administration is one of the three Technology names on the list. It has created a narrow economic moat in the Australian and UK financial services administration sectors via its leading positions in fund administration and share registry services. Client retention rates exceed 90% in both markets.

Link surged 25% last week on news that it had received a conditional, non-binding indicative proposal from a consortium comprising Pacific Equity Partners, Carlyle Group and their affiliates to acquire all of Link. Morningstar equity analyst Gareth James, who foresaw the takeover, says the $5.20 offer undervalues the company. "The offer is well below our $7.70 fair value estimate, meaning we're unlikely to recommend shareholders accept," James says. "Although the offer is at a 30% premium to the last closing price before the offer was announced, the shares are still 13% below where they were at the start of 2020."

Wide moat **InvoCare** is the largest funeral, cemetery, and crematorium operator in Australia, New Zealand, and Singapore. InvoCare owns a portfolio of 60 brands, including three national Australian brands: White Lady, Simplicity Funerals, and Value Cremations. 2020 has been a challenging year for InvoCare. Social distancing and an increased focus on sanitation amid the covid-19 pandemic has led to a benign flu season and a lower death rate. However, Morningstar analyst Mark Taylor expects InvoCare to gradually increase its market share and sales to grow at a mid-single-digit pace for the next five years. "Over the longer term, we expect the ageing and growing population to boost case volumes," says Taylor. ABS data suggests this is likely to accelerate after fiscal 2024, peaking at between 2 and 3% by 2032. "In our opinion, InvoCare is well positioned to capitalise on this growth, given its dominant position in the domestic market and its wide economic moat," Taylor says.

Australian Pharmaceutical Industries is the franchisor of the Priceline Pharmacy network and directly owns and operates stand-alone Priceline stores which sell personal care and beauty products. In an effort to diversify away from the highly regulated low growth and low margin pharma distribution business which contributes 75% of revenue, API is growing a consumer brands portfolio and also recently acquired Clear Skincare, a skin treatment chain. API carries a low uncertainty as Morningstar expects no anticipate any regulatory changes in the Pharmaceutical Benefits Scheme or pharmacy ownership legislation.

Cross-section of sectors

Telstra, Australia's leading telco provider, rose almost 4% during the compilation of this survey, but it remains materially discounted, according to the valuation of Morningstar equity analyst Brian Han. The nbn's $3.5 billion upgrade last month will affect Telstra and its rivals but it's too early to quantify, Han says. Telstra gained 3.96% to $2.89 on Monday after chair John Mullen told its annual general meeting the board wants to ensure investors' payout is not cut. The board is prepared to waiver some rules to maintain the full-year 16 cents per share payout.

Telstra generates around 40% of group operating earnings from the mobile telephony division. Its mobile subscriber base has ballooned from 12.2 million in fiscal 2011 (40% market share) to 18.8 million in fiscal 2020 (44% share). "The growth has been driven by the superior quality, speed and coverage of its mobile network," Han says, "one that is capable of offering triple plays (mobile, data, audio-visual media), further enhancing its competitive positioning compared with peers."

Financial services

Financial Services companies account for almost a third of the names on the list. And within that sector, three asset managers appear. In order of biggest discount to Morningstar fair value estimate, they are: Perpetual, Pendal Group and Platinum Asset Management.

Perpetual recorded a sluggish fiscal 2020, but Morningstar director of equity research Adam Fleck says investors should look past that as the future holds the prospect of stronger earnings growth. Key to this will be a couple of acquisitions it made this year: the 75% acquisition of US asset manager Barrow Hanley will help ward off index funds, while the acquisition of Trillium boosts its ESG credentials. It's also worth noting that Perpetual is the biggest shareholder in Link Administration.

Insurers NIB Holdings and Medibank Private round out the names within Financial Services.

Technology

Alongside Link Administration, two other narrow-moat-rated Technology sector names appear: Computershare and IRESS. Computershare has grown via global acquisition to become the world's leading provider of share registry services, which constitutes about 60% of earnings.

Morningstar's James says cost-cutting measures will help Computershare increase its pre-tax earnings from 22% in fiscal 2020 to 33% by fiscal 2030.

"The capital-light business model should enable regular dividends, the elimination of net debt within the decade, and a return on invested capital that exceeds the weighted average cost of capital for the foreseeable future," James says. "The recurring and defensive nature of earnings influences our medium fair value uncertainty rating."

Healthcare

In Healthcare, the other name alongside API is pharmaceutical distributor, wholesaler and pharmacy franchisor Sigma Healthcare. It is also the only name on the list that carries a Poor stewardship rating. The company has been slower than peers to diversify itself away from the low margin, low growth pharmaceutical distribution business, says Morningstar's Han. On a brighter note, however, covid-19 has had little impact, highlighting the inelasticity of demand for health products. "The firm expects a recovering EBITDA to better fiscal 2019 levels by fiscal 2023 and we share similar optimism," Han says. He retains his long-term estimates and forecasts a five-year EBITDA compound annual growth rate of 15%.

Real estate

Two real estate investment trusts make the cut. One is Charter Hall Social Infrastructure REIT, which is trading at a 21% discount to fair value. The other is GPT Group, which is Australia's oldest listed property trust (1971). GPT remains dominated by retail malls that generate about a third of its revenue, and another quarter from office.

However, the group's office portfolio is not as exposed to the immediate threat from the coronavirus, says Morningstar analyst Alex Prineas. "There has been very little new office supply in the Sydney or Melbourne central business district in the past five years so 2020 began with very tight supply, which we anticipate will loosen."

Utilities

Among the Utilities sector, two names feature: AGL Energy and Spark Infrastructure Group.

Morningstar equity analyst Adrian Atkins recently trimmed his valuation for AGL on lower expected wholesale electricity prices. However, he still considers the low-cost energy producer and retailer to be attractively priced with a solid balance sheet and dividend potential.

"Based on the current share price, we forecast an average dividend yield of 5.5% over the next five years," Atkins says, "with solid longer-term dividend growth as earnings recover. Dividends should be mostly franked except for during the next two years as historical tax losses reduce tax payments."

Spark Infrastructure owns 49% interests in three electricity distribution companies: Powercor, servicing western suburbs of Melbourne; CitiPower, servicing Melbourne's inner suburbs and central business district; and SA Power Networks, servicing South Australia. Powercor and CitiPower are collectively known as Victoria Power Networks. It also owns 15% of TransGrid, the main electricity transmission network in NSW. Atkins says that while Spark pays healthy distributions it is heavily regulated and faces a tough outlook as the Australian Energy Regulator seeks ways to reduce utility bills.

Lex Hall is Content Editor for Morningstar Australia. This article is general information and does not consider the circumstances of any investor.

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Why not use options to protect your share portfolio?

Tony Dillon

Many investors worry about their share portfolios. What if the next big fall is just around the corner? Will there be another pandemic like COVID-19 which saw the All Ordinaries index retreat almost a third in a month? Can investors afford such a big hit?

It all boils down to risk tolerance levels and the proverbial sleep-at-night factor. Can you reduce your risk while retaining share market exposure?

There is a way to protect portfolios and reduce risk by using options as a hedging strategy, an approach often referred to as portfolio insurance.

How do put options work?

In [an earlier article](#), I described an option as being a contract that gives the owner the right to buy (a 'call' option) or sell (a 'put' option) without obligation, a specific security at a specified price, on or before a specified date. The underlying security may be an individual stock or a sharemarket index. Options are versatile investment instruments, used to speculate, hedge risk, or derive income.

The hedging strategy works like this. I own a share in company ABC, currently trading at a price of $10 in the market. I want to maintain exposure to upside potential while eliminating downside risk. I therefore buy a put option at a price that gives me the right to sell my share at $10, on or before a future date.

If the share price exceeds $10 before the specified date, the option expires worthless and I can choose to retain or sell my share. If the share price is less than $10, I exercise my put option and sell the share for $10.

Options have a cost, but is it worth it?

In effect, I have insured against the share losing value, but reducing risk does not come without cost. Options cost money, and investors are often reluctant to protect their portfolios by purchasing put options, because they eat into income, often exceeding dividends received.

A key driver of price of the put option, called the premium, is volatility. Volatility in this context refers to expectations of variability in the stock's price movements, or the standard deviation of the stock's returns over a period (see the CBA example below). It is a forward-looking measure in option pricing. The higher the expected volatility, the more expensive the option, which would seem intuitive.

Take a simple example of a stock currently trading at $100. An option on that stock is priced with forward volatility of 10%, or one standard deviation. That means the market expects the stock to trade between $90 and $110, being plus or minus one standard deviation, 67% of the time. And it expects the stock to trade between $80 and $120 (plus or minus two standard deviations), 95% of the time (meaning less than $80 is only 2.5% of the time). Such price movements assume that stock returns are normally distributed.

A specific example using CBA

Consider now some real and current option premiums, such as CBA shares. The share price was trading on 20 October 2020 at $70.30. If I owned that stock and wanted close to full downside protection for the next month, I would buy a 19 November 2020 $70 put option, which was trading at a cost of $1.72. The cost in percentage terms was 2.4% of the value of the stock.

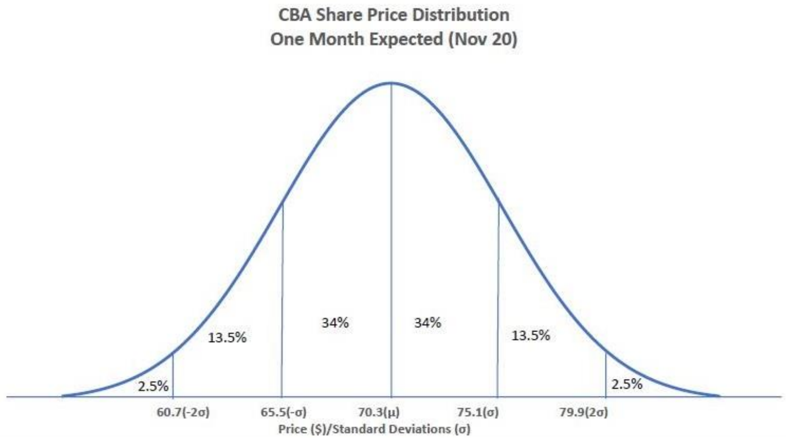
Clearly, rolling that type of protection over month after month, would become quite expensive. Over a year, the cost of protection would be approximately 29%, which dilutes the return on the portfolio considerably.

Investors simply would not be willing to pay for that level of insurance.

It is possible though to trade off some premium for an amount of risk by selecting an option at a lower strike price, much like a deductible (or excess) on car or home insurance. For example, downside risk may be limited to something arbitrary like say 5% or 10%, but a more sophisticated approach might set a dynamic threshold that moves with market volatility.

This can be achieved, for example, by selecting a monthly volatility at one standard deviation, which is a downside of 6.8% (see footnote for further explanation). In this case, we use a November $65 put, which could be purchased at a premium of $0.45. This reduces the insurance cost to 0.64% of the stock value, or about 7.7% rolled over for a year. A reduction in premium has been exchanged for exposure to some loss of value, and the cost is starting to become a little more palatable.

Investors, therefore, are able to select a strike price that matches their risk tolerance level.



But we can do better

Purchasing a put option provides protection from the strike price all the way down to a value of zero. Do we need that much protection? We have seen that the likelihood of a share falling more than two standard deviations is just 2.5%, much less going all the way to zero. So what if we took on still more risk, but with very low probability?

It is possible to negate the insurance below two standard deviations say, by 'selling' a put at that level. The downside risk is protected in the range from one to two standard deviations only. The 'sold put' is income offsetting the cost of the higher strike 'bought put'.

It works like this. One standard deviation is 6.8%, so again, a $65 put is bought for $0.45. And at two standard deviations, or movement of 13.6%, a $61 put is sold for $0.19. The net cost of the strategy being $0.26, or 0.37%, and an annualised cost of 4.4%, which may even be tax deductible, depending on an individual's financial circumstances.

This may be a workable cost for risk-averse investors, wanting to maintain capital value at the expense of some income.

The possibilities for the spread of risk accepted are endless. A more risk-averse investor may wish to take less risk up front and more in the tail. For example, buy a put option at half a standard deviation from the current stock price, and sell a put one and a half standard deviations out, with a 6.7% probability of going below that.

As expiry nears …

Just a note that if close to expiry, and the share price is trading below the bought put strike, the investor could do nothing and allow the option to be exercised. That is, the option seller would be obliged to buy the shares at the strike price above market. Or the investor could sell the put option, which would have value of approximately the difference between the strike price and the lower market price. The latter may be preferable if the investor wants to hold onto the shares and avoid buy/sell costs, and potential capital gains tax.

Hedging a share portfolio with put options is all about maximising upside potential and limiting downside risk. Like anything though, there is no such thing as a free lunch, and limiting losses costs money. With varying degrees of protection possible however, one can choose to spend as little or as much as their appetite for risk dictates.

Footnote on the 6.8% CBA downside example

The implied volatility is determined in the option pricing. One way to do this is to take the at-the-money put and call options, being those with strike price closest to the current stock price. Then calculate the implied volatility in both options, which can be done with a simple on-line calculator. Average the two volatilities, which should be similar, to obtain a proxy for our expected volatility of the stock. Note, this process will yield an annual volatility measure, which in this case must then be converted to the monthly equivalent.

Tony Dillon is a freelance writer and former actuary. This article is general information and does not consider the circumstances of any investor.

A-REITs offering much-needed income

Grant Berry

While Australian listed property stocks, or A-REITs, have gone through a challenging period during 2020, most are currently performing well and offer investors an attractive opportunity for income yield.

During the latest reporting season, most A-REITs did not provide much future guidance which is unusual, but this was more a result of the challenge in predicting the short-term future rather than any specific concerns about the property groups.

Indeed, A-REITs outperformed the broader Australian equity market during reporting season, returning 8% (compared to 3%) in August 2020 and this outperformance continued through September.

Income trajectory

On the whole, balance sheets across the sector are in good shape and within covenants, with increased available liquidity. As investors, our focus is now more on the income trajectory.

One of the key concerns about A-REITs during the lockdown was the impact it would have on rent collections and income. Across the sector, rent collections have varied. The most impacted were large scale and CBD-based retail A-REITs while sectors such as office, industrial and other subsectors were less affected.

Now, with the COVID-19 lockdowns relaxing across Australia, with the exception of Victoria, stores are opening, and foot traffic is returning, and this is leading to an acceleration in rent collection.

Encouragingly, despite the drop in rent collection, income yield across many A-REITs has remained strong and, as the situation improves, we see the potential for good upside in income yields. In fact, in some cases, distributions are back to the same levels they were before the COVID-19 outbreak.

Taking the diversified GPT Group (ASX:GPT) as a bellwether for A-REITs, over the six months to June 2020, it experienced around 80% rent collection, yet the most recent distribution rate annualised still provides a yield of around 5% on current pricing.

GPT Group – A Bellwether of REITs

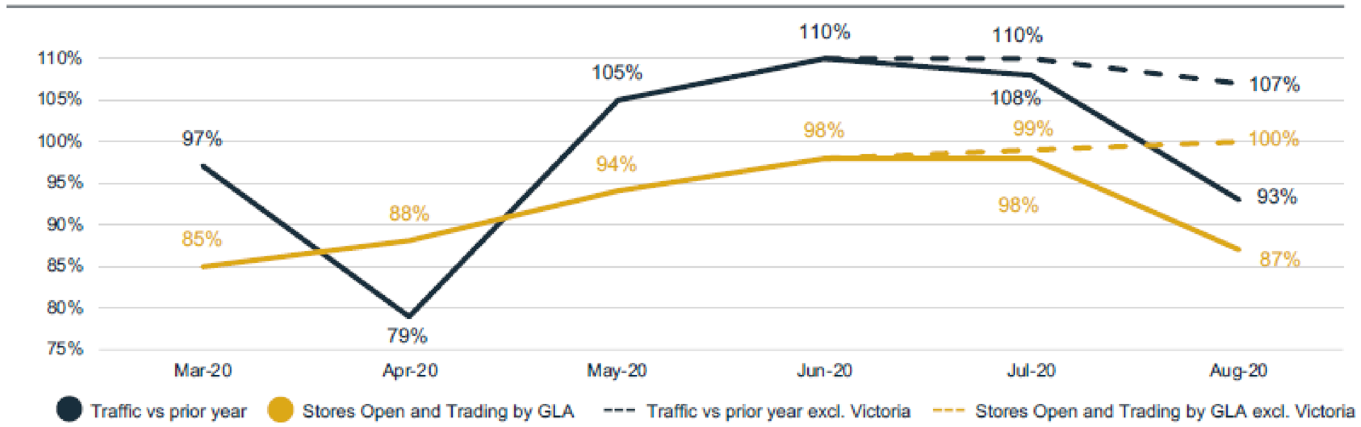
Rent Collection	Office	Logistics	Retail	Total
Quarter 1	99%	100%	90%	95%
Quarter 2	94%	98%	36%	67%
1H 2020	97%	99%	63%	81%

Another example is Aventus Group (ASX:AVN), Australia's largest owner and manager of large-format retail offerings across Australia. Aventus is arguably a barometer of what may transpire for other REITs, and why we are constructive on the sector as a source of income.

At the end of January 2020, Aventus had a share price of $2.99. Its most recent quarterly distribution at the time was 4.26 cents per share which annualised would have reflected 5.7% distribution yield.

Unfortunately, with the uncertainty of COVID, the distribution was cut to 1.06 cents per unit for the March quarter, while its security price hit a low of $1.36. By June, the quarterly distribution was increased to 2.35 cents. When Aventus reported its results in late August, foot traffic (excluding Victoria) was actually above the prior year levels.

Traffic Rebounded as Centres Opened



Source: Aventus

Its most recent September quarterly distribution was increased to 4 cents, similar to pre-COVID levels, and the security price at the end of September was $2.36 cents. The annualised rate therefore reflects a yield of 6.8%, or more than 100 bp higher than that in January.

In the meantime, long-term interest rates have also come down, making the case for alternative sources of income even more compelling. This provides the backdrop for further re-rating potential and likely a signpost for what may transpire for some other REITs.

Positioning for the recovery

A key question for investors is whether they continue to focus on the 'stay at home' theme or whether they start to position themselves for the 'recovery'.

We have seen the 'stay at home' theme resonate throughout equity markets as companies that benefit from this trend – such as Amazon, Netflix and the like – experience soaring share prices. This has carried through into the A-REIT sector, with those groups having some association with e-commerce (logistics) or data (data centres) at high prices, while much of the traditional A-REIT sectors such as retail and offices at low prices.

In our view, some stocks at such extreme levels are over-extrapolating the 'stay at home' theme, whereas the reality is that there will be a return to normality as COVID-19 runs its course or when a vaccine is rolled out.

Therefore, we are positioning for the recovery trade, and there are some strong and compelling opportunities in real assets, which are out of favour at the moment that will benefit from the return to normality.

We are also seeing some good opportunities in alternative real estate, such as land lease communities, storage and childcare centres – which are currently a good source of income, diversification and re-rate potential.

However, we believe it is important to not overlook traditional core real estate in the A-REIT sector because that's where investors can find the deepest value and some real opportunities in the current market.

Grant Berry is a Director and Portfolio Manager at SG Hiscock & Company. SG Hiscock & Company Ltd (ABN 51 097 263 628, AFSL 240679) may hold positions in companies mentioned in this article. This is general information and is not intended to constitute a securities recommendation. While the information contained in this presentation has been prepared with all reasonable care, SG Hiscock & Company accepts no responsibility or liability for any errors or omissions however caused.