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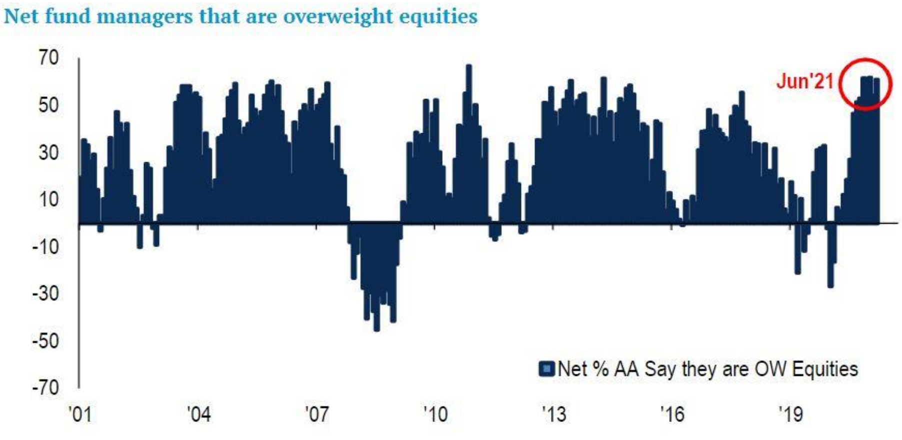
Contents

Editorial

Despite lofty valuations, a higher than expected 5% annual inflation rate published last week in the US and new strains of the virus, fund managers and financial advisers are increasingly weighting portfolios to equities. Each month, **Bank of America** publishes a Global Fund Manager Survey, and for June 2021, BofA found asset allocators (AA) are:

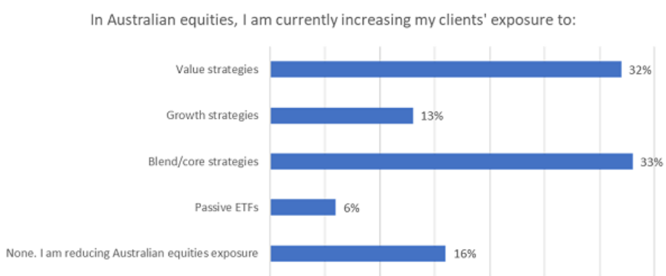
" ... bullishly positioned for permanent growth, transitory inflation and a peaceful Fed taper via longs in commodities, cyclicals and financials".

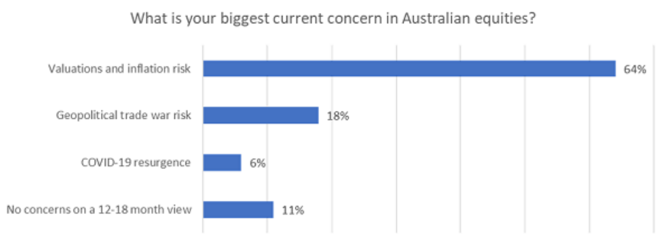


Source: BofA Global Fund Manager Survey

At the **Morningstar Investor Conference** (MIC) last week, mainly comprising over 500 financial advisers, only 16% were reducing their clients' exposure to Australian equities, while many were increasing in value and core strategies.

When asked at MIC about their biggest concerns, most cited valuations and inflation risk, with few worried about COVID. How quickly we move on.





It was the same in the BofA fund manager survey, with 66% nominating their biggest tail risk as either inflation or a taper tantrum (that is, the market reacting badly to central banks withdrawing support).

It's an unusual combination of allocating more to equities amid high concerns about inflation and rising rates. A record number of companies are mentioning inflation in the market updates they give during their earnings outlooks.

A good example of rapidly rising costs is container shipping spot rates. The vital trade route from Shanghai to New York shows supply chain disruptions and an accelerating upward trend in shipping costs. As trade reopens, higher demand for oil will be another factor which tests whether inflation is really 'transitory'.

Rates in dollars per FEU. Green line = Drewry weekly Shanghai-New York. Blue line = Freightos daily Asia-East Coast. Chart: FreightWaves

While on inflation, we should acknowledge a moment in history which shows the merit of government spending on productive assets at the moment. For the first time ever, the Australian Government paid a negative interest rate of minus 0.01% on part of $1 billion borrowed from institutions last week. At some point, debt needs to either rollover or be paid back, but it's certainly cheap while it's out there.

Damien Klassen recently published an exhaustive 7,000-word, four-part review on his inflation expectations which he has summarised into a shorter article for our purposes. He concludes that the investments that might protect a portfolio from inflation have already had their run and current high inflation is supply-chain based and temporary.

In this week's lead, **Dawn Kanelleas** identifies five companies in her portfolio that she holds based on the outlook over the next five years, not because she is jumping aboard some prediction about a COVID recovery.

Then **Greg Lander** checks the performance of a wide range of LICs and LITs between the previous peak in January 2020 and the end of March 2021. How well did they manage the rapid fall and recovery in a sector that has some strong results despite the recent criticisms?

Rudi Filapek-Vandyck identifies a stock market segment that has delivered excellent results recently, away from the headlines. He says it would be front page news if achieved in other parts of the market.

Then two articles on important subjects not receiving enough attention. **Bill Pridham** highlights the terrible impact of single-use plastics on our environment, and how regulations will hit some companies. He has invested in one business that is confronting the issues. And **Will Baylis** defends the rights of fund managers to use the research of proxy advisers and he argues the Government's desire to stamp out their influence is going too far.

Finally, like the market, we can't leave the inflation genie in the bottle. **Stephen Miller** asks what it will take for the RBA to change its highly accommodative stance on bond purchases, interest rates and lending to banks.

The White Paper from **Perth Mint** is a detailed review by **Jordan Eliseo** on the role gold can play in diversified superannuation strategies based on market data and super funds across the risk spectrum for almost 30 years.

We had a lively debate (36 comments so far) on **Emma Davidson**'s article about declining fertility but our favourite Comment of the Week came from **Simon (Luke Skywalker) Samuel** who joined in the spirit of our comparison of LICs and ETFs with Marvel and Star Wars, writing:

"No one is going to be unhappy buying an asset for 80% of its value and collecting outsized yields as a result. The problem is that unless you are Palpatine (the Emperor of the Galactic Empire who seemingly lives forever) and so don't ever need to sell those LICs, you are only going to get 80% of any capital appreciation the underlying fund investments make until such time as the discount narrows meaningful. Most of the time, you need to rescued by activists (the Force) to be able to crystallise the full capital gain. Don't forget that in the beginning, a long long time ago, those first investors in LICs paid 100% or more for those investments, and those people are not best pleased to be faced with having to sell at 80% of the value when they or their estate trustees need to sell out."

Finally, the power of a healthy celebrity and a viral clip. Watch what happens when **Cristiano Ronaldo** pushes away two bottles of Coke during a press conference. It wiped billions from Coke's market value. **Warren Buffett** will not be pleased.

Five stock recoveries not hanging on COVID predictions

Dawn Kanelleas

Let's face it. We couldn't predict COVID and we couldn't predict the impact on the economy of the stimulus and which sectors would benefit. We couldn't predict the fact that people would start buying more because they weren't traveling and all the other consequences of the COVID recovery.

What we can do is pick stocks, using a disciplined investment process to find businesses that have sustainable competitive advantages on a three- to five- year view, with strong financials that we believe will preserve investor capital in a crisis like COVID where the market collapses precipitously.

With or without COVID, investors want businesses with predictable earnings and recurring revenues, especially disruptive businesses benefitting from change in the global economy, with a large addressable market.

Here are some examples of what happened during COVID.

Two great Australian companies, ARB and Breville

The first two stocks are companies that we have owned in our portfolios for over 10 years. We believe that over three- to five- years, they will innovate and export their IP from Australia to the world, where they have low market shares relative to their penetration in Australia.

ARB Corporation (ARB) is a 4X4 accessories producer that has spent more than 30 years investing in R&D on its products. It has cash on its balance sheet and a big distribution network in Australia and increasingly, overseas.

Breville (BRG) not only makes toasters and small items but also sells $4,500 coffee makers in many countries around the world. In fact, their sales in the US are 2.5 times the sales in Australia and in Europe, they're 1.5 times. Breville is growing rapidly but they own only a small part of the appliance market globally.

The price charts of the two companies are below.

Source: Factset. Price returns shown. Data 31 December 2019 to 31 May 2021.

When COVID hit, the market sold ARB as investors thought nobody was fitting accessories to their vehicles. What actually happened - and we couldn't predict this - was that people couldn't go to Bali or Disneyland and they bought second-hand four-wheel-drives because they couldn’t buy new ones. And then they spent $50,000 a pop on 4X4 accessories, and that happened in both Australia and the US generating record earnings for ARB.

Likewise with Breville, as people initially thought stores would close and nobody would replace their home appliances. What actually happened was people stayed at home when the coffee shops shut, or people did not feel comfortable going out, so they bought top-of-the-range coffee makers for their own espresso at home. And they bought rice cookers and bread makers, plus they shopped online in both Australia and the US, either directly or through various other means. The result was worldwide record sales.

Clearly, we couldn't predict what happened. What we did was pick great businesses with a three- to five-year view, and then we bought more as the earnings came through. Many of our peers may have sold out because they thought earnings in these companies would collapse or underperform when stores closed.

But we didn’t make any recovery prediction. We stuck by our opinion and these companies suddenly became incredibly cheap on a longer-term view of two great Australian companies. The businesses were already growing at double digit, and then COVID supercharged them.

Online travel will also recover

We have two long-term travel holdings in our portfolio because they are global, Australian businesses leveraged to the travel market. Corporate Travel Management (CTD) is a global leader in business travel, having invested in innovative software which is driving efficiencies for its customers globally. It's gaining market share but with many company employees not travelling, the share price of CTD has not recovered to pre-COVID levels, as shown below.

Source: Factset. Price returns shown. Data 31 December 2019 to 31 May 2021.

Similarly with Webjet, which is a long way off its high. It is better known for its Business-to-Consumer travel in Australia, where people go to the web portal for tickets. This part of the business is recovering, but it's a digital company. On both companies, we take our three- to five-year view despite the hit from COVID. Webjet still has a way to go because holiday travel has yet to recover, but it is a digital platform delivering travel solutions to companies and to consumers.

Source: Factset. Price returns shown. Data 31 December 2019 to 31 May 2021.

We don't own Flight Centre because we've taken a view around the lack of a sustainable competitive advantage in its business. It is far less of a digital business. We are concerned about the balance sheet liability associated with its significant store lease footprint that we believe will be challenged in the future.

IDP Education as a global provider

IDP Education delivers English language testing globally, especially for students studying at English-speaking universities in the UK and North America. It was adversely impacted by COVID initially, but what actually panned out was that in the UK, the market was open to international students to the detriment of Australia. North America was also open and IDP was able to sell more of its digitally-enabled market-leading university placement products. COVID helped in bringing forward its digital business.

Source: Factset. Price returns shown. Data 31 December 2019 to 31 May 2021.

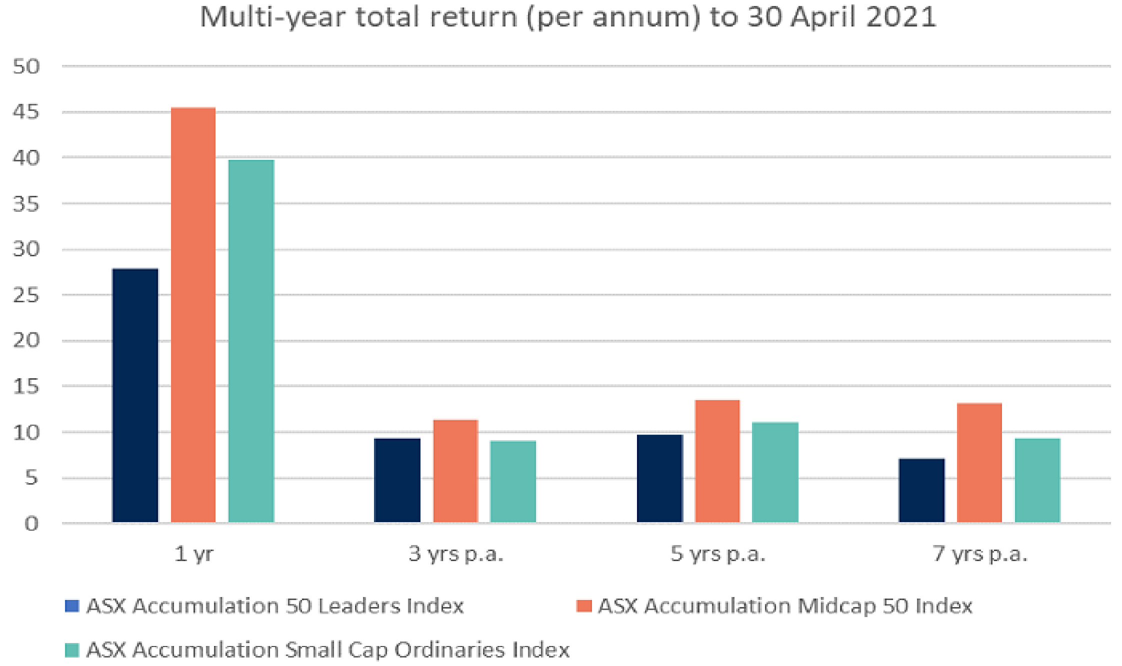
Australia is still not open to international students but IDP returned to pre COVID price levels quickly. We think this is a great business that is disrupting an industry using its English language client base to start a student placement programme, which is gaining share globally.

What about the higher income from banks?

We are often asked questions on banks and bank yields. The following chart shows that despite the heavy position of high-yielding banks in 50 Leaders Index, the small cap and mid cap indexes have done better over any of time periods in the chart. These total returns include the attractive yields that the banks deliver.

The key takeaway is that if an investor can identify businesses that are innovative and growing and can protect capital due to privileged assets with long-term contracted revenue, they should deliver better returns over time.

Bank yields or innovation and growth? Small and mid caps taking the lead.



Source: Bloomberg. Total returns shown to 30 April 2021.

Where are we now in the cycle and outlook for small and mid cap companies?

The answer is very stock specific. We have recently seen some major falls in overpriced companies where investors did not understand the risks. While the Small Cap Index is up about 27% in the year to end-May 2021 and our portfolio has outperformed over the same period, it's unlikely we will see such results again. There are strong, disruptive businesses but there are also pockets of small caps that are overpriced, especially when they don't have a strong business producing free cash flow and funding their own growth. But businesses with sustainable competitive advantages, strong financials and predictable earnings should continue to do well.

Dawn Kanelleas is Head of Australian Small and Mid-Cap Companies at First Sentier Investors, a sponsor of Firstlinks. This article is for general information only and is not a substitute for tailored financial advice. Any stock mentioned does not constitute any offer or inducement to enter into any investment activity.

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Peak to peak, which LIC managers performed during COVID?

Greg Lander

The 14-month period from 31 January 2020 to 31 March 2021 was an excellent opportunity to assess whether a fund manager did a good job. That's because January 2020 was the last monthly high before the pandemic hit markets and in March 2021, the ASX200 Accumulation Index broke even again. If you had invested in the ASX200 over this period, your return would have been just 0.7%.

This period features both the downturn and the upswing. Although it's a short period, it is, in effect, a complete market cycle. These are the periods when active managers should outperform (and earn their fees). If they haven't, you are entitled to ask some hard questions.

So we checked this market high to market high to see how LIC managers performed. Did LIC managers add value? Who made money, and who didn't?

How we did it

For this exercise, we wanted to measure the investment performance of the LIC manager. So, we ignored changes in LIC share prices and looked only at the change in underlying NTA plus dividends and distributions. This excludes the impact of other market forces, such as changes in discounts to NTA.

Generally, discounts and premiums magnify market ups and downs. For example, if you had taken the plunge and bought a LIC in March or April 2020, it's almost certain that the current premium or discount is better than when you bought.

We looked at the change in pre-tax NTA plus dividends and distributions paid between January 2020 and March 2021. This penalises LIC managers slightly by including the impact of tax on realised gains. It also does not consider the effect of any corporate actions such as options and capital raisings. Even so, as you will see below, most managers still performed admirably after this handicap. For LITs, the trust structure means that, like ETFs and unlisted managed funds, there was no direct tax cost to handicap them.

We also highlight areas where active management has worked best, broken down by strategy. In many cases, particular LICs could have qualified in more than one strategy but we have placed LICs with the peer group we felt is the best fit.

Australian Large Cap Equities

For larger ASX stocks, where the ASX200 Accumulation Index delivered 0.7% for the period, we've used this as a benchmark. Results varied widely.

No doubt the star of the show was Perpetual. PIC delivered a total return of 21.5%. The result was helped by a small allocation to global equities and a resurgence in some of their favoured value stocks. Perpetual is genuinely differentiated from the index and it shone through. Other key outperformers were Katana Capital, helped by a decent allocation to resources, Flagship Investments, AMCIL and WAM Leaders.

What about the three largest LICs? AFIC and Milton added a small amount of value while Argo slightly underperformed.

At the wrong end of the table, we have AFIC stablemate Djerriwarrh, where some upside from the recovery may have been lost via their strategy to write call options. Clime Capital performed poorly while Contango Income Generator suffered as income stocks were hammered during COVID. This eventually resulted in the manager completely changing this LIC's strategy.

So, a mixed bag from large cap LICs with over 40% return difference between the best and worst performers.

ASX Large Cap LIC Investment Performance

NTA based returns for selected ASX Listed Investment Companies for 14m from 1 Feb 20 to 31 Mar 21.

Code	Name	Total Return	Outperformance
PIC	Perpetual Equities Investment Company	21.5%	20.8%
KAT	Katana Capital	15.7%	15.0%
FSI	Flagship Investments Limited Ord	9.7%	9.0%
AMH	Amcil Ord	8.8%	8.1%
WLE	WAM Leaders	6.4%	5.7%
AFI	Australian Foundation InvesCo Ord	2.6%	1.9%
MLT	Milton Corporation Ord	2.4%	1.7%
	ASX200 Accumulation Index	0.7%	
ARG	Argo Ord	-0.2%	-0.9%
PL8	Plato Income Maximiser	-1.3%	-2.0%
QVE	QV Equities Limited	-2.1%	-2.8%
CIN	Carlton Ord	-2.3%	-3.0%
WHF	Whitefield Ord	-2.4%	-3.1%
DUI	Diversified United Ord	-2.7%	-3.4%
BKI	BKI Investment Company Ord	-2.9%	-3.6%
AUI	Australian United Ord	-3.6%	-4.3%
DJW	Djerriwarrh Ord	-5.0%	-5.7%
CAM	Clime Capital Ord	-8.0%	-8.7%
CIE	Contango Income Generator	-22.4%	-23.1%

Performance includes the change in Net Tangible Assets plus Distributions for the period.
Source: Affluence Funds Management, ASX. • Created with Datawrapper

Australian Small Cap Equities

Small caps are where the real opportunities exist for active managers, and most managers delivered in spades. The ASX Small Ords Accumulation Index did better than the ASX200 Accumulation Index over the period, with a 7.9% total return versus 0.7% for the ASX200.

Overall, 15 of the 21 small cap LICs, or around 70%, outperformed the Small Ords, many of them handsomely.

Unbelievably, both the top and bottom performers were managed by Thorney. This shows the stark difference that an investment style can make, even when run by the same management team. The technology focused TEK delivered a 30% return while old school value hunter TOP was the worst performer. TOP performance was made significantly worse by the management agreement with Thorney, which allows the performance fee hurdle to reset every year. This meant the $35 million loss suffered by shareholders in the 2020 financial year could be ignored. It resulted in a performance fee of $5.5 million in the second half of 2020 despite shareholders still being underwater.

Special mention must go to the team at Monash, who performed significantly better than most in the downturn and continued to add value during the recovery. In addition, they recently completed the transition of MA1 from an LIC to a listed managed fund, eliminating the considerable NTA discount and introducing a 6% per annum distribution target.

ASX Small Cap LIC Investment Performance

NTA based returns for selected ASX Listed Investment Companies for 14m from 1 Feb 20 to 31 Mar 21.

Code	Name	Total Return	Outperformance
TEK	Thorney Technologies Limited	30.0%	22.2%
OZG	Ozgrowth Ord	25.8%	18.0%
MA1	Monash Absolute Investment Coy	24.0%	16.2%
MIR	Mirrabooka Ord	22.9%	15.0%
FOR	Forager Australian Shares	21.4%	13.6%
ECP	ECP Emerging Growth	20.5%	12.6%
ACQ	Acorn Capital Investment Fund	20.3%	12.5%
NAC	NAOS Ex-50 Opportunities Company	19.6%	11.7%
WMI	WAM Microcap	16.8%	9.0%
NSC	NAOS Small Cap Opportunities	16.7%	8.8%
SEC	Spheria Emerging Companies Limited	16.6%	8.7%
RYD	Ryder Capital Limited	16.1%	8.3%
SNC	Sandon Capital Investments Limited	13.8%	5.9%
OPH	Ophir High Conviction Fund	12.0%	4.2%
WAX	WAM Research Limited Ord	8.4%	0.5%
	ASX Small Ords	7.9%	
WAM	WAM Capital Ord	6.3%	-1.5%
WIC	Westoz Investment Company Ord	4.0%	-3.8%
GC1	Glennon Small Companies	-1.0%	-8.9%
NCC	NAOS Emerging Opportunities Coy	-4.8%	-12.7%
NGE	NGE Capital Limited	-6.2%	-14.0%
TOP	Thorney Opportunities Ltd	-16.8%	-24.7%

Performance includes the change in Net Tangible Assets plus Distributions for the period.

Source: Affluence Funds Management, ASX. • Created with Datawrapper

Global Equities

The MSCI All World Index returned 7.8% for the 14-month period, while US and many Asian indices fared even better.

Platinum Asia and the flagship Platinum Capital did well as the value style slowly came good after a long period of underperformance. Other good performers included the successful Hearts and Minds Investments, WCM's US-focused global growth strategy, Morphic Ethical Equities and PM Capital, another value manager.

Two poor performers stand out. MFF Capital investments struggled after remaining overweight cash and missing a significant portion of the recovery. Argo Global is focused on listed infrastructure which has remained one of the areas most impacted by COVID.

ASX Global LIC Investment Performance

NTA based returns for selected ASX Listed Investment Companies for 14m from 1 Feb 20 to 31 Mar 21.

Code	Name	Total Return	Outperformance
PAI	Platinum Asia Ltd	25.2%	17.4%
HM1	Hearts and Minds Investments Limited	20.8%	13.0%
WQG	WCM Global Growth	17.0%	9.2%
MEC	Morphic Ethical Equities Fund Limited	16.1%	8.2%
PGF	PM CAPITAL Global Opps Fund Limited	15.0%	7.2%
VG8	VGI Partners Asian Investments	11.5%	3.6%
APL	Antipodes Global Investment Co Ltd	10.6%	2.8%
PMC	Platinum Capital Ord	10.2%	2.4%
TGG	Templeton Global Growth Fund Ord	9.5%	1.7%
EAI	Ellerston Asian Investments Limited	9.1%	1.2%
PIA	Pengana International Equities	9.9%	2.0%
	MSCI All World Index (AUD)	7.8%	
GVF	Global Value Fund Limited	7.1%	-0.7%
PAF	PM CAPITAL Asian Opps Fund Limited	7.0%	-0.8%
WGB	WAM Global	4.5%	-3.3%
VG1	VGI Partners Global Investments	2.4%	-5.5%
GFL	Global Masters Fund Ord	1.1%	-6.7%
MHH	Magellan High Conviction	-0.5%	-8.3%
MFF	MFF Capital Investments Limited	-13.5%	-21.4%
ALI	Argo Global Ltd	-14.2%	-22.1%

Alternative Strategies

The alternative strategies group covers LICs that seek absolute returns, using tools such as shorting or carrying significant extra cash.

L1 Long Short Fund, despite being one of the most impacted initially on the downside, has recovered spectacularly well. They correctly recognised early in the recovery period that vaccines were likely to be highly effective and positioned the portfolio to benefit from value plays and the recovery trade. Regal Investment Fund, which incorporates a range of investment styles, also performed well. This was somewhat assisted by gearing embedded in some strategies. On the flipside, AEG, a geared market neutral fund, has struggled in an environment where value stocks have made a a comeback.

ASX Absolute Return LIC Investment Performance

NTA based returns for selected ASX Listed Investment Companies for 14m from 1 Feb 20 to 31 Mar 21.

Code	Name	Total Return	Outperformance
LSF	L1 Long Short Fund	52.6%	51.9%
RF1	Regal Investment Fund	49.9%	49.2%
CDM	Cadence Capital Ord	23.4%	22.7%
FGG	Future Generation Global Investment Co	10.0%	9.3%
FGX	Future Generation Investment Fund	9.0%	8.3%
	ASX200 Accumulation Index	0.7%	
WAA	WAM Active Limited Ord	0.4%	-0.3%
AEG	Absolute Equity Performance Fund	-10.5%	-11.2%

Performance includes the change in Net Tangible Assets plus Distributions for the period.

Source: Affluence Funds Management, ASX. • Created with Datawrapper

Alternative Assets

Our alternative assets group includes LICs investing in non-standard asset classes.

Outperformers included all three of the CD Private Equity Funds and Bailador's Technology focused private equity LIC.

The one disappointment was Pengana's Private Equity LIC. Despite weathering the downturn well, the recovery has been meagre for Pengana. It was not helped by the appreciation of the Australian dollar nor the additional capital raised by the manager.

ASX Alternative Asset LIC Investment Performance

NTA based returns for selected ASX Listed Investment Companies for 14m from 1 Feb 20 to 31 Mar 21.

Code	Name	Total Return	Outperformance
CD3	CD Private Equity Fund III	23.2%	22.1%
BTI	Bailador Technology Investment Ltd	18.1%	16.9%
CD1	CD Private Equity Fund I	12.8%	11.6%
CD2	CD Private Equity Fund II	5.7%	4.5%
TGF	Tribeca Global Natural Resouces Limited	2.6%	1.5%
WMA	WAM Alternative Assets	1.1%	0.0%
	ASX200 Accumulation Index	0.7%	
PE1	Pengana Private Equity Trust	-6.1%	-7.2%

Performance includes the change in Net Tangible Assets plus Distributions for the period.

Source: Affluence Funds Management, ASX. • Created with Datawrapper

Corporate and Real Estate Debt

Despite being a relative newcomer to the sector, debt focused LITs have primarily done their job. However, most of them traded at substantial discounts to their net asset value at some stage in 2020, requiring investors to hold their nerve to achieve the returns.

Two LITs from Metrics and one from Qualitas, both high-quality Australian managers, are at the top. All three delivered good results with no material loan losses. Of course, it helps that they hold private or unlisted debt, which is not marked to market like publicly-traded debt.

ASX Debt LIC Investment Performance

NTA based returns for selected ASX Listed Investment Companies for 14m from 1 Feb 20 to 31 Mar 21.

Code	Name	Total Return
MOT	MCP Income Opportunities Trust	9.2%
QRI	Qualitas Real Estate Income Fund	7.1%
MXT	MCP Master Income Trust	5.6%
GCI	Gryphon Capital Income Trust	5.5%
PCI	Perpetual Credit Income Trust	4.0%
NBI	NB Global Corporate Income Trust	3.5%
KKC	KKR Credit Income Fund	1.6%
PGG	Partners Group Global Income Fund	0.8%

Performance includes the change in Net Tangible Assets plus Distributions for the period.

Source: Affluence Funds Management, ASX. • Created with Datawrapper

On the flipside, LITs from KKR and Partners Group generally have exposure to offshore publicly traded debt, which has not fared as well. We would also argue that this type of asset has a higher embedded risk. Indeed, these were also two of the most volatile LICs last year.

What have we learned?

From market peak to trough, and back to peak again, we've seen surprisingly diverse results from LIC managers, including many outstanding performers.

What lessons can we learn from this? Here are eight key takeaways, although these comments may apply to managed funds in general.

1. The more a manager can deviate from a benchmark, the higher their chance to outperform. Of course, this also comes with a risk that they underperform. But if you choose talented managers with an excellent long-term track record, you've probably made a good start.

2. Look carefully at what the manager is doing and question their competitive advantage. For example, it's harder to outperform in the biggest stocks. On the other hand, small cap managers and alternative

strategies where the manager can have an information or skill advantage can deliver good results in choppy markets.

3. Diversification is worthwhile. Picking one or two LICs might work, but it is better to have at least five and up to 10 for a diversified LIC portfolio.
4. Investment style matters. Certain styles will outperform or underperform, potentially for long periods. Sometimes, that means two different LICs run by the same manager can have vastly different results.
5. Bigger is not better. The performance of larger LICs was average overall. Most of the stellar results came from the medium and smaller sized LICs.
6. Alternative strategies and alternative assets can be attractive diversifiers and perform relatively well when other investments struggle.
7. Debt LITs did their job, eventually, with Australian assets and Australian managers delivering. Investors stomached volatility along the way.
8. Finally, LICs can be an attractive addition to your portfolio. Increasing your allocation during times of market stress, when NTA discounts are higher and active managers can do their best work, can deliver outstanding investment results.

Greg Lander is a Portfolio Manager at Affluence Funds Management. This article is intended to provide general information only. It should not be construed as tax, legal or investment advice as it has been prepared without considering your objectives, financial situation or needs.

Blink and you missed a seismic shift in these stocks

Rudi Filapek-Vandyck

If you are a share market investor who still reads newspapers in print, you may casually glance over the property section on your way to, say, the share price pages, sport updates or the weekly cultural agenda. If so, you may have missed one of the most profound changes taking place in the valuation of financial assets.

It is the reason why some of Australia's owners of bricks and mortar have been among the best performers on the ASX in recent weeks, including Centuria Industrial REIT (CIP), Goodman Group (GMG) and Charter Hall (CHC), with share prices up circa 27% in all three cases in less than three months.

As always, there are multiple drivers in place, but investors should not simply assume that a generally more relaxed attitude towards inflation, as also expressed through much less volatile bond markets, is the sole responsible factor for this remarkable bounce in share prices.

Quality industrial is the new black

An important clue of what is driving share prices of the property owners and developers mentioned can be found in the recent market update lodged by Centuria Industrial REIT to the ASX on 1 June 2021.

In it, Australia's largest listed pure play owner of industrial assets revealed a general re-assessment of the asset portfolio had led to an 11% increase in like-for-like book values, in large part the result of the Weighted Average Capitalisation Rate falling by -42bp to 4.53%.

If this had been an announcement made by a producer of iron ore, gas, copper or even poultry or cattle, the news would have been splashed across the front pages of major newspapers, with highlights on the evening news bulletins.

But industrial property?

What we are experiencing is potentially a seismic shift in the valuation of highly sought-after bricks and mortar assets. It is driven by the fact that assets such as data centres and modern warehouses have a direct link to new megatrends such as e-commerce and the explosion in data usage. And more traditional property assets, including offices and shopping malls, now carry a lot of question marks about their value and use-by date.

Investors in the share market are still debating whether work-from-home is here to stay and in what capacity, or how much more value depreciation lays ahead for shopping malls in CBDs and quiet neighbourhoods. But it appears large investors in property markets have already made up their mind.

From the aforementioned Centuria statement:

"*Australia's industrial real estate market remains a highly sought-after sector attracting investment demand from domestic and international capital. Within the past six months the market has seen elevated transaction volumes with major asset and portfolio sales setting new benchmarks, which has resulted in significant compression of capitalisation rates compared to previous reporting periods. A substantial weight of capital continues to create competition for quality assets.*"

Lower cap rate means higher values

For those who are less familiar with the specific lingo used, Weighted Average Capitalisation Rate or 'cap rate' is effectively the income from the property as a percentage of the total value ascribed.

If you pay $100 and the contractual income is $5 per annum, the cap rate is 5%.

But here's where strong demand and changing risk perceptions are starting to change property market values and dynamics.

A cap rate of 5% seemed pretty final up until last year. In 2021, as also indicated by that ASX statement, the cap rate for a modern, quality industrial asset is trending towards 4.5%, and potentially closer to 4%.

What this means, in our example of an asset valued at $100, is that investors are now willing to purchase that same property for $110, bringing the cap rate down to 4.5%. Were that cap rate to drop to 4%, the same property would be worth $125.

It has taken a while but the share market is now genuinely paying attention. And so is the rest of the sector. No doubt, similar revaluation updates are being prepared at Goodman Group, Charter Hall and other listed owners of similar properties, including Charter Hall Long WALE REIT (CLW), Stockland (SGP), GPT Group (GPT) and Mirvac (MGR).

All have experienced firm share prices in recent months, though not necessarily in line with the three peers mentioned earlier. The real stand-out, however, is Mirvac whose share price has now rallied more than 30% since bottoming in February. Mirvac also brings along a firm leverage to domestic residential markets, as well as offices and commercial retail.

In similar vein to, for example, Charter Hall, Mirvac's portfolio also includes assets that might have to be devalued (office and retail), but investors are taking the view the positives from the industrial assets portfolio outweigh any negatives.

Goodman Group and the 'value' debate

The above would in particular apply to Goodman Group and Charter Hall whose creating-value-for-shareholders strategies are closely intertwined with asset management and new project development.

Within this context, it is telling that sector analysts at JP Morgan recently discussed whether Goodman Group should now be treated as a high-quality growth stock on the ASX.

JP Morgan suggests the answer is 'yes'. On its assessment, current projects under development virtually guarantee 10-15% per annum in sustainable growth in Assets under Management (AUM) and management fees. The broker also believes that were margins and developments to come under pressure, the company's balance sheet can be used to support growth in earnings.

JP Morgan believes Goodman Group's strong growth profile will last for the next 3-4 years, with a projected 14% CAGR in earnings per share over the next three years. Ultimately, the broker acknowledges, annual growth in EPS will revert back to the old and familiar 6-8%, but few investors would be concerned about such slowing in today's context.

Years ago, Goodman Group used to be a staple for retirees seeking steady income from the share market. The re-rating of the stock that has occurred since has triggered many calls of over-valuation. It is fair to conclude those calls were looking in the rear view mirror and wrong, as the share price has continued to set new all-time record highs.

Chart 1: Goodman Group (A$)

Source: Morningstar.com.au

Goodman Group shares have now doubled in value since mid-2018. Clearly, sector analysts at JP Morgan don't think the share price has travelled far enough north just yet, as also indicated by the fact all seven stock brokers in the FNArena universe who cover the stock still hold a positive view.

The upcoming asset revaluation update is simply another positive in support of a share price that is now trading on a forward multiple of 28x on FY22 consensus forecasts for an implied dividend yield of 1.5%.

Mind the differences

For Charter Hall, which is a lot smaller than Top 20 member Goodman Group, the numbers look slightly different with FY22 forecasts implying today's PE multiple is only 21.5x for a yield of 2.7%.

Investors should not assume the exact same dynamics apply equally to all companies in the sector. Charter Hall combines two of Goodman Group's prime features - asset management and industrial project development - with offices, commercial retail and social infrastructure. Its EPS growth profile, judging from the years past, is also less steady and predictable.

Chart 2: Charter Hall Group (A$)

Source: Morningstar.com.au

Centuria Industrial REIT is yet again another few steps down from Charter Hall in terms of market capitalisation. Given its much less diversified scope, it is valued in more traditional REITs style, being dividend yield relative to bond yields. The share price is probably due a pause, but nevertheless supported by strong industry dynamics.

A potential turning point for property valuations

The conclusion from all of the above is that we might be witnessing a major schism inside property market valuations driven by COVID-19 and identifiable megatrends that will remain with us for many more years to come.

Assessing the exact impact and consequences won't be easy for investors, as no two assets are identical, while most REITs and asset owners have different portfolios, profit drivers and strategies.

But times they are a-changing and for the likes of Goodman Group, Charter Hall and Centuria Industrial REIT it is more than plausible this year's new dynamic will cement their profile as the better growth alternative among peers.

Rudi Filapek-Vandyck is Editor at the FNArena newsletter, see www.fnarena.com. This article has been prepared for educational purposes and is not meant to be a substitute for tailored financial advice.

Worries over the planned proxy rule changes in Australia

Will Baylis

The Australian Treasury recently issued a consultation paper on changes to proxy advice that mirror some of the proposals issued under the US Trump administration. To us, the new rules are founded on a misguided notion that the proxy voting sector lacks transparency.

We believe that the rule changes would, if anything, undermine the rights of asset owners to vote as they wish and give companies undue influence on proxy recommendations and outcomes.

We recently made a submission to the Treasury consultation outlining our concerns as to why this is not in the best interests of our clients or the market more broadly. We outline the key points of our submission below.

Proxy voting is a core element of our active ownership approach

We have long believed that it is our job as fiduciaries to make a stand where we see an issue which could detract from good governance, sustainability, and investor outcomes. Annual General Meeting (AGM) season (typically October to December in Australia) is a critical time to re-emphasise our stance regarding a board's progress on ESG matters through engagement and the voting of proxies.

In order to vote proxies for our clients, we do our own internal assessments of boards and management with a comprehensive investment process which includes our actions taken in relation to voting for AGMs and shareholder resolutions. We supplement this with the input of external providers to provide additional insight to company financial accounts, AGM resolutions and assessment of directors who are up for re-election.

Unlike what is being suggested by the Treasury rules, we do not agree with the premise that institutional investors that use proxy advisors are overly influenced by the research provided by them.

The reality is that we frequently disagree with the views of our proxy advisors. In 2020, we voted differently to the proxy advice provided in 12% of resolutions. And where we did agree, it was often for different reasons than those stated in the proxy advisor report. Ultimately, our voting is undertaken based on an assessment in the best interests of our clients.

Sharing recommendations with companies in advance may compromise independence

The Treasury has suggested a number of changes, one is that proxy advisors should provide their report containing the research and voting recommendations to the relevant company before investors.

We do not agree with this approach.

Directing the distribution of independent research recommendations to issuers in advance of its release compromises the expectation that this research will be independent of the issuer.

We also do not want to see undue costs and time delays added to the process of proxy advisors. Independent researchers should be able to rely on a company's public documents and meetings with company executives, without any requirement to provide them with draft research in advance.

Increased costs from additional regulation will impact returns for investors. Given the Government and regulator focus on affordable, low-cost superannuation, we are concerned about the increased costs of proxy regulation.

The ASX is already established as a forum to enable issuers to provide continuous disclosure to an informed equity market. A company can make an announcement on its website or via the ASX and does not require the proxy adviser to do so.

Proxy advisors are already well regulated

Proxy advisors are in a competitive industry. Our preferred advisors engage regularly with ASX-listed companies and include the issuer's views on AGM proposals. We also value the fact that our Australian proxy advisor has an Australian Financial Services licence (AFSL) as it relates to providing credible insights regarding the company's financial accounts and AGM resolutions.

What we expect is for ASIC to continue to regulate the proxy advisors such that if a proxy advisor is found to not show professional conduct or independent research, then in a manner similar to other regulated entities, the license to operate is reviewed and remediation actions are taken.

To require additional licensing would be regulatory overkill. The best analysis is driven by excellent financial research and each analysis of resolutions at AGMs or EGMs always contains opinion about the company's historical or forward-looking financials.

We also note that the ASIC review of proxy adviser engagement practices in June 2018 was extensive, and concluded that:

"voting allows shareholders to express their views on important issues as well as hold the Board to account for the company's performance".

This is central to why we have our own investment team and access to multiple proxy advisors who can add valuable and independent insight.

Inertia and increased influence of company directors on proxy recommendations

Finally, one of our key issues with this consultation paper is that it is focussed on the wrong issues.

The extremely low 4-7% 'Vote Against Management' average by shareholders for ASX company resolutions[1] highlights that inertia, exacerbated by the shift to passive investment management, is a bigger issue than a so-called lack of transparency from proxy advisors.

Our challenge as an institutional investor is to hold boards and management to account. This can only be done via independent research and good financial accounting insight. In 2020, we voted against management in 12% of resolutions[2], well above the ASX historical average. Our team also conducts over 1,000 meetings with company management each year, and our long history of constructive engagement between our investors and management teams places us in a strong position to be proactive and effect change.

Our biggest concern is that the implementation of the Australian Treasury's change could instead exacerbate influence of company directors on proxy recommendations, the reverse of the consultation paper's objectives.

We do not want to see any change that increases the ability of company directors to prevent independent scrutiny of their governance practices and behaviours.

Will Baylis is a Portfolio Manager at Martin Currie Australia. Martin Currie is the manager for the Legg Mason Martin Equity Income Fund, also available as an Active ETF (Managed Fund) ASX:EINC. Martin Currie is a Franklin Templeton specialist investment manager, and Franklin Templeton is a sponsor of Firstlinks. This article is general information and does not consider the circumstances of any individual. Past performance is not a guide to future returns.

For more articles and papers from Franklin Templeton and specialist investment managers, please click here.

[1] Source: Martin Currie Australia, ASIC; as of 31 December 2020. Average against vote by resolution type by ASX 200 company shareholder, simple average of each type. 5% in 2016, 4% in 2017, 7% in 2018 (based on Figure 6 in ASIC REP 609 Annual general meeting season 2018.)

[2] Source: Martin Currie Australia. In 2020, for the 972 resolutions for stock holdings in portfolios managed by the Martin Currie Australia team, we voted against management in 116 resolutions.

How to invest as inflation fears fade

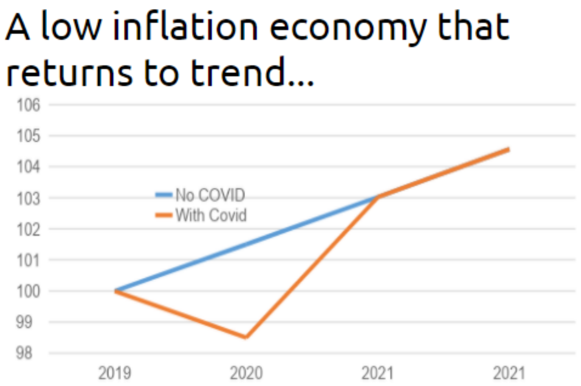
Damien Klassen

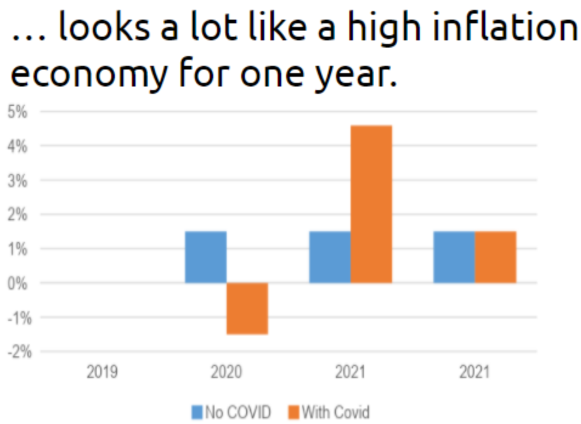
Last week, the US reported annual inflation of 5%, the highest since 2008. Pundits are suggesting investments in anything from commodities to value stocks will protect portfolios from rising inflation. My take is these assets have already run. But the current owners do need someone to sell to, which is why these stories abound. Current inflation is supply-chain based, temporary, and the recent price signals might even create the opposite effect.

Why is today's inflation different from the 1970s?

The world has changed. The structure of today's economy is radically different to the 1970s and 1980s.

1. **Base effects**. Most of the inflation is either in the supply chain or comes from starting at a low base, both of which will pass.





Stimulus cheques do create inflation by boosting demand, but a one-period inflation spike does not create ongoing inflation.

2. **Economic orthodoxy has been over engineered to prevent inflation**. Stagflation was rampant in the 1970s and 1980s. The end came when central banks (led by the US) showed they were prepared to cause recessions to 'anchor' inflation expectations. Just as importantly, new rules were enacted to ensure inflation wouldn't return:

a. Monetary system: Independence from political intervention for central banks, inflation targets, various rules on government money printing.

b. Oil prices: The best solution to high commodity prices is high commodity prices. A wave of investment and increased supply meant oil prices stopped rising.

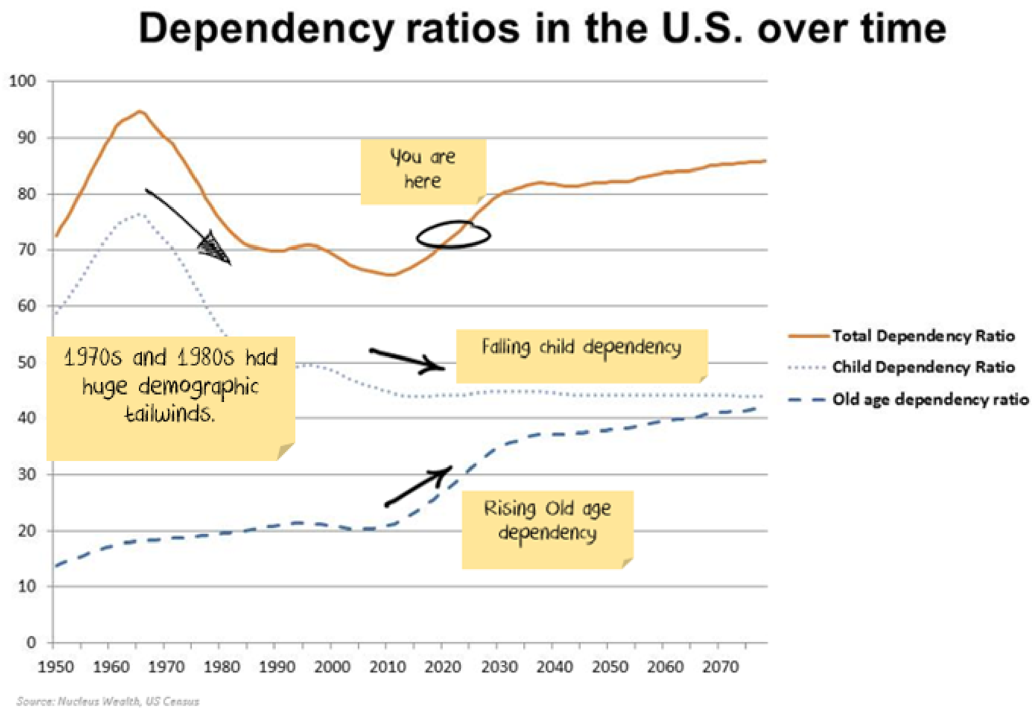
c. Deregulation: A range of industries changed from public to private ownership, lowering costs.

The pendulum has swung too far. The steps taken to prevent inflation have entrenched disinflation.

3. **Inflation expectations**. Low inflation expectations have become entrenched. Employees have stopped demanding continual wage rises. It took 30 years for expectations to fall from 5% to below 2%. A jump to higher inflation expectations is unlikely to be quick.

4. **Changing economic structures and demographics**. In most developed countries, manufacturing has shrunk as a proportion of the economy by a third since the 1980s. Union membership has plummeted. This puts even more focus on wages, as wages are the largest cost for service companies. The 1970s and 1980s saw significant financial reforms which dramatically increased debt levels. While debt is increasing, inflation increases, but high levels of debt are deflationary.

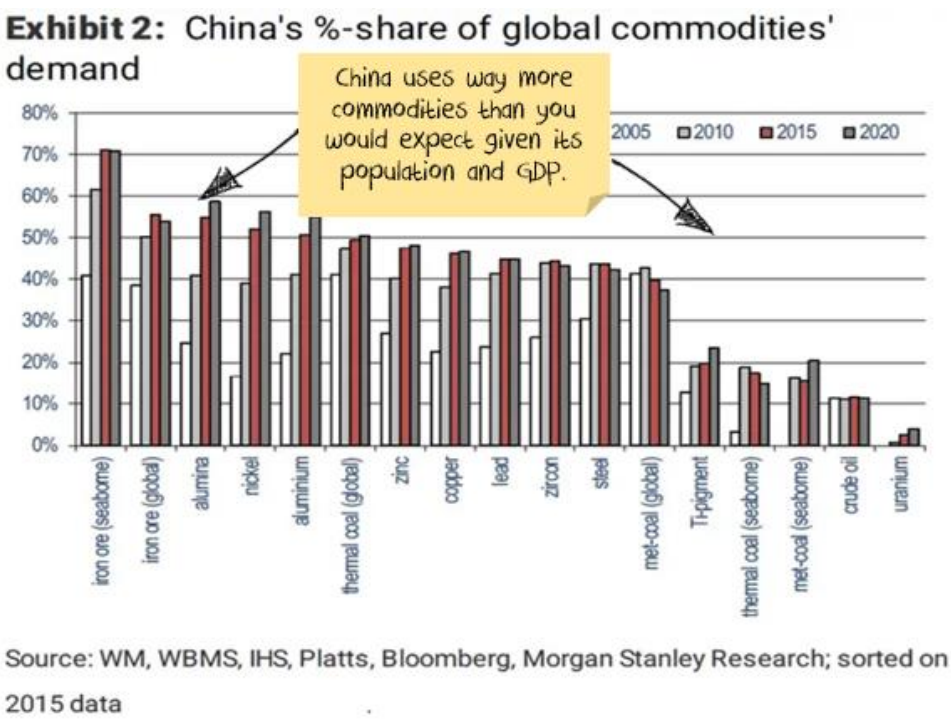
Finally, demographics are no longer a tailwind, as shown in the dependency ratio.



5. **Technological innovation**. In recent decades, the internet disintermediated entire industries, reducing costs, increasing competition and lowering inflation. Energy and automation will be the drivers for the 2020s.

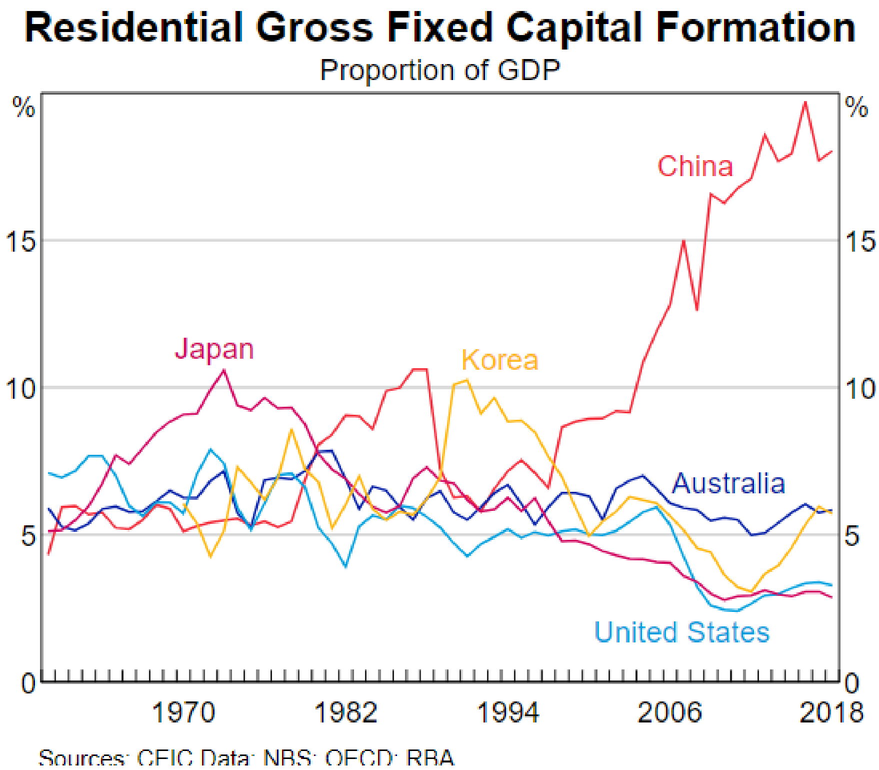
China's impact on commodity prices

China uses an incredible amount of commodities relative to its size. This is not a long-term phenomenon. It has arisen in the last 20 years:



The real culprit is the Chinese construction sector, far more than other infrastructure, and even railways are not as steel-intensive. The big consumer of steel is high-rise buildings.

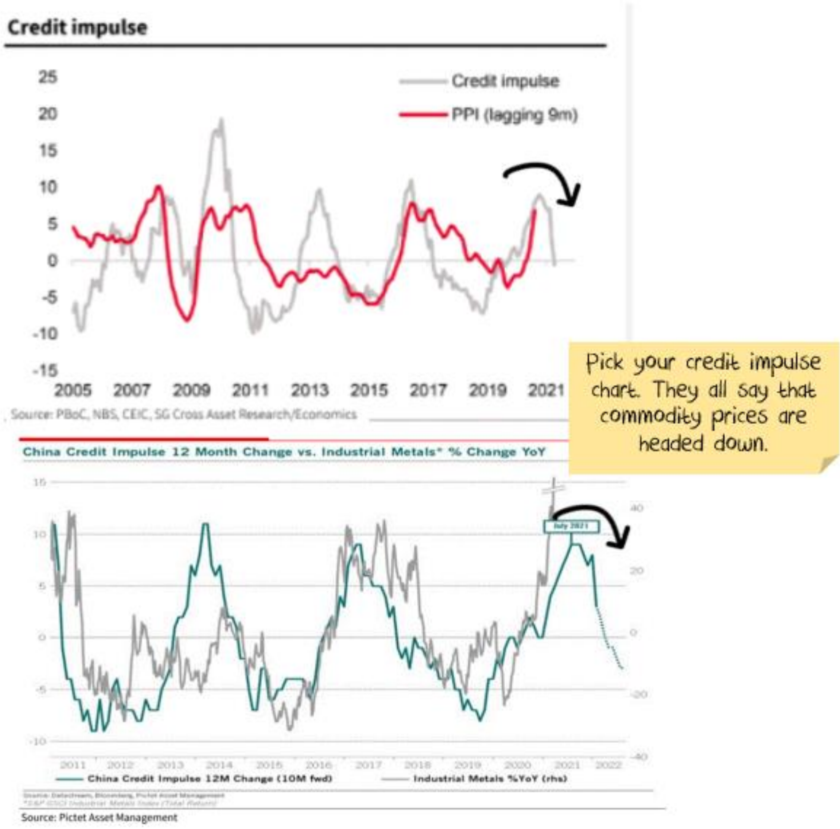
Residential investment in China, as a proportion of GDP, is double the level of Japan before its housing crash and three times higher than the US before its housing crash.



Over the long term, we expect this to converge to more normal levels, particularly due to demographic headwinds.

What about US infrastructure? Won't this increase commodity demand? CRU estimates $US1 trillion of US infrastructure will need about 6 million tons of steel and 110 tonnes of copper per year. Both are less than 0.3% of the current world annual supply. The net effect is that commodity inflation is far more leveraged to Chinese stimulus than developed market stimulus.

Again, on its own, this suggests a longer-term downside for commodity demand, but the overspend could last for years. The reason we are concerned is that credit growth has come to a halt (right charts)



Several investment banks are pitching the story that investors need commodity exposure to protect from rising inflation. A weak Chinese construction market will blow that story out of the water.

There are both long-term and short-term reasons for the construction cycle to be peaking in China. Commodities are standing in the blast zone.

What is an inventory cycle?

The basis of most business cycles has an inventory cycle at the core. The stocking and de-stocking cycles are what typically drive economies both into recession and out of recession.

Assume we have:

- A retailer who buys from a wholesaler
- A wholesaler who buys from a manufacturer.

We are looking at the changes from period to period. For some companies, the periods are days. For others, the periods are weeks, months, or quarters. Both the retailer and the wholesaler target 1.5x the current period's sales as inventory.

It looks like this:

Steady State

	Period 1	Period 2	Period 3
Retailer			
Sales	100	100	100
Inventory	150	150	150
Inventory / Sales	1.5	1.5	1.5
Wholesaler			
Sales		100	100
Inventory		150	150
Inventory / Sales		1.5	1.5
Manufacturer			
Sales			100

The retailer assumes they will keep selling 100 units. They want to keep their inventory at 1.5x sales and so order 100 units from the wholesaler

The wholesaler does the same.

Now let us look at the effect of a drop in demand. Say sales drop 10% for the retailer and then stay at the new level:

As you can see, the effect is more significant further down the supply chain. A 10% fall in sales for the retailer is a 60% fall for the manufacturer. In the initial stages of a recession, this effect worsens the cycle as manufacturers then fire staff and pull back spending. However, it works in the other direction as well. When the cycle turns, the opposite effect kicks in.

Drop in Sales

Sales drop to 90.

	Period 1	Period 2	Period 3	Period 4	Period 5	Period 6
Retailer						
Sales	100	100	100	90	90	90
Inventory	150	150	150	160	135	135
Inventory / Sales	1.5	1.5	1.5	1.8	1.5	1.5
Wholesaler						
Sales		100	100	100	65	90
Inventory		150	150	150	185	135
Inventory / Sales		1.5	1.5	1.5	2.8	1.5
Manufacturer						
Sales			100	100	100	40

Inventory grows to 160 because of unsold goods. But retailer only wants 135 now (1.5 x 90 of sales)

The Retailer's order is now only 65, which means inventory spikes

And so the order for the Manufacturer is only 40

Sales Growth	Period 4	Period 5	Period 6
- Retailer	-10%		
- Wholesaler		-35%	
- Manufacturer			-60%

The drop in sales gets exponentially larger the further down the supply chain.

An extraordinary convergence = an inventory super cycle

Demand for goods has been temporarily boosted by:

- Lack of other options as services like travel and recreation were shut.
- Government stimulus, both direct and indirect.
- Pent up demand as consumers who built up savings and are now spending.
- A need for greater inventories from businesses to mitigate against future supply shocks.

Meanwhile, supply has been temporarily constrained by:

- Lockdown constraints on workers.
- Changes in demand. For example, more demand for houses, less for apartments. Manufacturers/suppliers need to change processes.
- The Suez Canal blockage.

If we are in a super-cycle where demand increases and then returns to trend, it will be a wild ride for manufacturers. But inventory cycles are short. The price signals of today are building the excess capacity of tomorrow. The signs are good for economic growth but are not indicative of rampant inflation.

How to invest as inflation fears fade

The current rotation into value will not fare well if inflation fades. Indeed, it will be the worst place to invest as equity duration risk disappears for a time. There are three main options as to how the market treats the factor rotation changes:

- Inflation falls back and lifts corporate profits, supporting ongoing high valuations, but 'value' gives way to mid-cycle 'quality'. In this scenario, investors should own longer duration bonds plus quality growth equities.

- Inflation falls, yields collapse and stocks violently rotate back to the 'growth' stock bubble. In this scenario, longer duration bonds rise (yields fall) plus growth equities catch a bid. This is not for the faint of heart. If the non-profitable growth bubble re-inflates, it will be temporary. This scenario is best characterised as a tradeable bear market rally.

- Central banks commit a policy error by following hawkish leads in China, New Zealand and Canada. The Fed tightens directly into the growth and inflation cliff ahead (even discussion of a taper will be enough). This will deliver a growth shock to markets alongside the deflation shock. It will force yields higher briefly before equities tumble. The entire reflation trade could collapse until the Fed reverses course. In this third scenario, a larger allocation of longer-duration bonds is the key. Equity allocations should be cut and repositioned like scenarios one or two.

The three scenarios represent an investment horizon of 12-18 months as the inventory super-cycle and commodities bubble deflate owing to a combined Chinese and US growth air pocket that ends the great stimulus and global reopening boom.

From there, we will still have low unemployment in the US with a large Biden stimulus lifting US growth towards 3% per annum for years. This holds out the real prospect for better wage gains and a grind higher for inflation through the cycle.

Damien Klassen is Head of Investments at Nucleus Wealth. This article is general information and does not consider the circumstances of any investor.

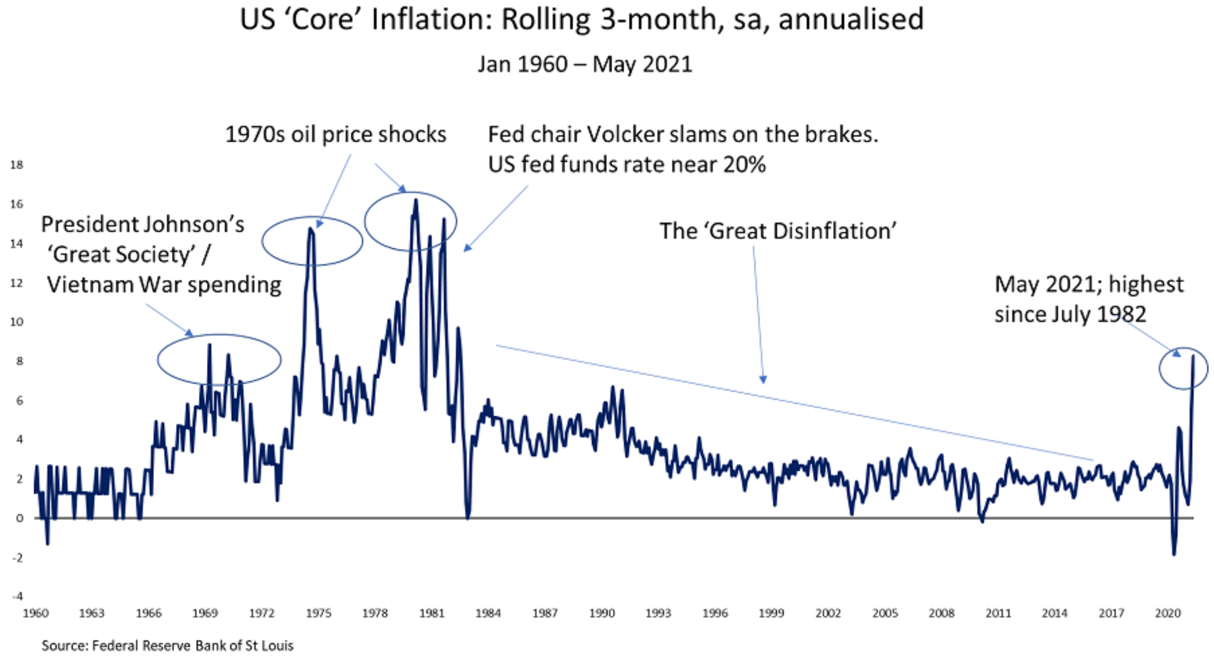
A tale of the inflation genie, the Fed and the RBA

Stephen Miller

Inflation is the topic du jour in global financial markets.

The parameters of the debate appear to be focussed on the likelihood of some persistent inflation, and potential financial stability concerns, in the absence of a timely withdrawal of the historically high levels of monetary accommodation currently being applied by central banks.

In the US the most recent May inflation report showed annual ‘core’ inflation at its highest level since 1992. In the past three months US inflation was running at an annual rate of 8.3%, the highest since 1982.



Plenty of inflation evidence

Moreover, the inflation pulse continues to beat rapidly. Purchasing managers report suppliers struggling to meet demand. Order backlogs are at their highest in 40 years, and commodity prices are surging.

In Warren Buffet's annual address to Berkshire Hathaway investors, he stated that he was seeing "very substantial inflation".

Obama-era Treasury Secretary Larry Summers, former Pimco Head and Allianz adviser Mohamed El-Erian and BlackRock CEO Larry Fink, have all expressed concerns regarding inflation as well as some of the latent financial stability dangers.

They cite inflationary pressures mounting from:

1. The boost in demand created by the $US2 trillion-plus in savings that Americans have accumulated during the pandemic
2. Historically high levels of monetary accommodation including large-scale US Federal Reserve debt purchases and Fed forecasts of essentially zero interest rates into 2024
3. $US3 trillion in fiscal stimulus passed by the US Congress
4. Soaring stock and real estate prices.

Further, inflation may yet accelerate due to demand growth outstripping supply growth, rising materials costs and diminished inventories and the impact of inflation expectations on purchasing behaviour.

The Biden agenda, including higher minimum wages, strengthened unions, increased employee benefits and strengthened regulation - while replete with laudable intent - all push up business costs and prices.

The main argument - is it transitory?

However, US Federal Reserve Chair, Jerome Powell, continues to assert that any inflation will be "transitory" and reflect short-term supply imbalances as the economy recovers from the dislocation wrought by the COVID pandemic. Neither does the Fed Chair display any overt concern regarding financial market imbalances.

However, on occasion, unless addressed, 'transitory' inflation can take on an air of permanence. In the words of former Australian Prime Minister Keating "the inflation genie gets out of the bottle," and once that occurs, it is a difficult process getting that genie back.

That is precisely what happened with the oil price shocks of the 1970s when policy generally 'accommodated' the increase in oil prices. Not that the current circumstance is entirely redolent of what took place back then.

For the time being the bond market has given the Fed the benefit of the doubt and has bought the 'transitory' narrative. Nevertheless, the time is fast approaching when the Fed needs to articulate an exit strategy from the historically high levels of monetary accommodation.

Were the Fed to indicate that it is 'thinking about thinking about' the retreat from current levels of monetary stimulus, that would be timely for the RBA.

Inflation less evident in Australia

Inflationary pressures are present but less visible in Australia. The fiscal boost was way less than that applied in the US and the prospective regulatory agenda less ambitious.

While base effects will see June quarter annual 'headline' inflation likely get close to 4%, the RBA's preferred trimmed mean measure is forecast to be around 1.5%, still well south of the RBA's 2-3% target. Indeed, the RBA forecasts only have inflation reaching the bottom of the 2-3% inflation target band in June 2023, and even then, wages are forecast to be running at a paltry 2.25%.

The RBA has achieved its stated objective in pursuing yield curve control and QE of "keeping the AUD lower than it otherwise would have been". In my view, it will not wish to unwind those achievements by prematurely foreshadowing a significant retreat from the currently historically high levels of monetary accommodation.

Were the Fed to signal that it is reviewing or about to review its level of stimulus, the capacity for the RBA to signal its own (ever so slight) retreat is enhanced without exerting unwanted upward pressure on the AUD.

Given the RBA's unequivocal commitment to full employment, and given that despite progress on the unemployment front, it is still some way north of the 4% or even "3 point something" previously cited by the Governor as getting close to capacity, the RBA is likely to implement only marginal adjustments to its QE programme. Changes will be implemented flexibly and with caution, perhaps by signalling a likely weekly run-rate of purchases of bonds say between $2.5-$4 billion a week, which would follow the expiration of the current six-monthly $100 billion programme in September.

Such measures are at this stage rather small in the scheme of things given the prevailing expectation of the RBA Board that a policy rate increase is "unlikely to be until 2024 at the earliest."

It remains the case that while the economy's performance has certainly exceeded expectations, recent price and wage growth remains at levels that are still uncomfortably low for the RBA and its inflation and employment objectives, and the economy is still some way from a level consistent with full capacity.

Whilever that remains, and while ever the Fed persists with current settings, and while ever there is no 'lived experience' of adequate wage and price inflation, we should expect the maintenance of the historically high accommodatory tack from the RBA.

A Fed retreat would give the RBA sufficient cover to commence a calibrated and marginal retreat.

But keep an eye out for that genie. If you see it, then it really might get interesting!

Stephen Miller is an Investment Strategist with GSFM, a sponsor of Firstlinks. He has previously worked in The Treasury and in the office of the then Treasurer, Paul Keating, from 1983-88. The views expressed are his own and do not consider the circumstances of any investor.

For more papers and articles from GSFM and partners, click here.

Not so plastic fantastic: solving the single-use pandemic

Bill Pridham

We continue to hear more about the circular economy and how businesses can maximise their use of finite resources while minimising external pressures on our environment. The Ellen MacArthur Foundation has a great report titled "*The New Plastics Economy, Rethinking the Future of Plastics*" which highlights environmental concerns, along with potential solutions, regarding our use of the "ubiquitous workhorse material", plastics.

Only 5% of plastic is properly recycled

The report highlights that while plastics deliver highly functional properties at a very low cost, the drawbacks are becoming increasingly apparent. Approximately 95% of plastic packaging material value, or US$80-120 billion **annually**, is lost to the economy due to its short first use cycle.

More than 40 years after the launch of the first universal recycling symbol, only 14% of plastic packaging is collected for recycling. When additional value losses in sorting and reprocessing are factored in, only 5% of material value is retained for subsequent use.

More worrying is the likely acceleration of this trend. The report highlights that currently at least 8 million tonnes of plastics leak into the ocean each year, the equivalent to one garbage truck every minute. If no action is taken, this is expected to increase to two trucks per minute by 2030 and four per minute by 2050. This is unsustainable and while the plastics economy is highly fragmented, the collection and recycling infrastructure must rise to help minimise this issue.

Fortunately, this issue is high on the agenda of business, governments and individuals and the general consensus is that the response needs to be accelerated but the question is how and at what cost.

Single use plastics are, as the title suggests, only used once or for a short period of time before being discarded. Consumers are increasingly rejecting the use of single use plastics prompting governments around the world to implement regulations.

The EU Directive was passed in July 2019 with the stated aim:

"to prevent and reduce the impact on the environment of certain plastic products and to promote a transition to a circular economy by introducing a mix of measures tailored to the products covered by the directive, including an EU-wide ban on single-use plastic products whenever alternatives are available".

Plastics and business risks

Given the short lifecycle, single use plastics are more likely to be found in our oceans and the European Union estimates that 70% of all marine litter is attributable to these 10 most commonly found single use plastic items:

- Cotton bud sticks
- Cutlery, plates, straws and stirrers
- Balloons and sticks for balloons
- Food containers
- Cups for beverages
- Beverage containers
- Cigarette butts
- Plastic bags
- Packets and wrappers
- Wet wipes and sanitary items

The first-ever Europe-wide strategy on plastics is a part of the transition towards a more circular economy which is focused on sustainable, nontoxic reusable products and reuse systems rather than to single use products in an effort to reduce the quantity of waste generated. Beverage bottles are one of the most common forms of litter in the EU.

In our view, any consumer branded product utilising plastics and not addressing this issue will face significant long-term business risk or conversely, develop long-term consumer loyalty if dealt with properly.

Blue Planet II aired in 2017 and since then consumers have been vocally against the irresponsible applications associated with single-use plastic. As David Attenborough stated in his closing remarks in Blue Planet:

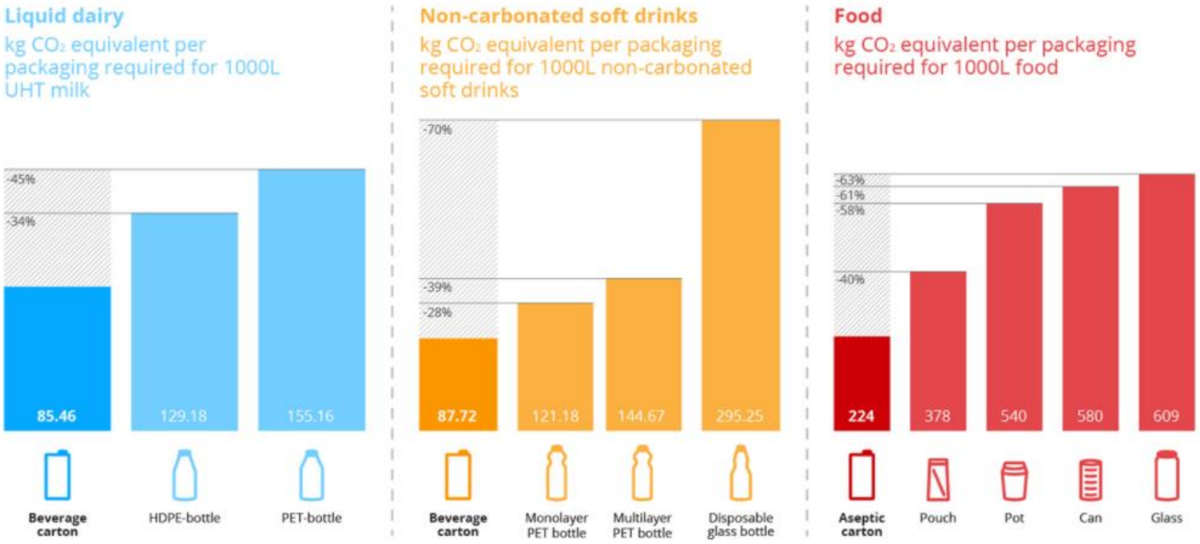
"We are at unique stage in our history. Never before have we had such an awareness of what we are doing to the planet, and never before have we had the power to do something about that. Surely we have a responsibility to care for our blue planet. The future of humanity, and indeed all life on Earth, now depends on us."

Investment opportunities

We have investments in companies which are at the forefront of addressing this issue however the most relevant to consumer packaging is our investment in SIG Combibloc which is based in Switzerland. SIG understands that consumers want to be loyal to a brand which clearly communicates its green efforts while being totally transparent about its processes.

According to the 2018 European Consumer Packaging Perceptions Survey of 7,000 shoppers, three quarters of consumers now say the environmental impact of a product's packaging affects their purchasing decisions and 90% want packaging to be easily recyclable.

To analyse the carbon footprint of its carton packs, SIG commissioned independent experts to conduct [lifecycle assessments](). In every assessment, the lifecycle carbon footprint of a carton pack was found to be significantly lower than other packaging alternatives - by as much as up to 70%:



Source: SIG

SIG cartons are made from 70-80% liquid packaging board (LPB), which comes from wood, a bio-based and renewable resource. Trees can grow quickly and be regenerated at a sustainable rate, absorbing carbon dioxide as they grow. This means the LPB in its packs, which are allowed to carry the Forest Stewardship Council™ certification label (licence code: FSC™ C020428), has a [very low carbon footprint compared with other packaging materials]() such as plastic (PET).

All the materials in SIG cartons can be recovered and recycled. Carton board is often used to make high-grade tissue, helping that product shrink its carbon footprint. This is because recycled materials need less energy to produce than virgin materials.

SIG has already taken steps towards a 100% renewable pack by [creating combibloc EcoPlus]() - an aseptic packaging solution that has a significantly smaller lifecycle carbon footprint than the standard aseptic pack. By using a different material structure, it has eliminated aluminium, replacing it with an ultra-thin polyamide layer. This increases the share of renewable materials in the pack from 75% to 82% and cuts the carbon footprint by up to 28%.

Source: SIG

The key takeaway here is that consumers are demanding environmentally friendly packaging products, governments are regulating and limiting the use of harmful plastics and consumer branded businesses are adopting new innovative solutions. Hopefully we can show the Earth she can depend on us.

Bill Pridham is a Portfolio Manager at [Ellerston Capital](). This article is general information and does not consider the circumstances of any investor.