Firstlinks
a Morningstar company

Edition 416, 16 July 2021

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Editorial

Noise. It causes such basic errors in our decision-making (including investing) that a new book from three top-selling US authors is called: **'*Noise: A Flaw in Human Judgement*'.** The examples in the book include wide variations in prison sentences for the same crime and insurance assessors awarding different damages for the same event.

Two key points in the book include:

*"**First**, judgement is difficult because the world is a complicated, uncertain place. This complexity is obvious in the judiciary and holds in most other situations requiring professional judgement … Disagreement is unavoidable wherever judgement is involved. **Second**, the extent of these disagreements is much greater than we expect."*

The authors are no less than **Daniel Kahneman**, author of the wonderful *Thinking, Fast and Slow,* **Cass R Sunstein**, author of the famous *Nudge* and **Olivier Sibony** of *You're About to Make a Terrible Mistake*. That's an impressive trio spending 454 pages on noise.

Source: CNBC and Seeking Alpha

So with all this noise hitting us every day, we should be forgiven for wondering what the heck is going on in financial markets. Rising virus cases with a new strain amid all-time market highs. Falling long-term bond rates amid rising inflation. Loss-making companies valued in the billions. We have witnessed a year of incredible stockmarket returns, despite headlines on one day saying (see below) '*the Dow's best week since 1938*' and '*16 million Americans have lost jobs*'. As the book says, "*the world is a complicated, uncertain place."*

It's a strange time when **Elon Musk** gains profile by tweeting **inciteful** messages about nothing, while **Warren Buffett**'s **insightful** thoughts are criticised because he's 'old school'.

Amid this noise, here are the returns (complied by **BetaShares**) from various stockmarkets as the pandemic has dominated every new bulletin for the year:

- Everyone's a winner but the US, driven by big tech, was up 41% versus Australia's 28%.
- The worst-performing global sector was that 'safe harbour' in tough times, utilities, up only 13%, and the goods we all need, consumer staples, only 18%. Technology topped the charts at 45%.
- And we are told about Japan's slow growth due to a declining population, up 31%, and 'old industry' Europe up 30%.

The **Morningstar** chart below places this in a long-term context. In fact, the 30-year average annual returns across Australian equities (9.8%), international equities (8.3%), A-REITs (8.6%) and international fixed interest (7.6%) are surprisingly close. What is not close is the risk involved to achieve those returns, as shown in the standard deviations below. They confirm the cost of the superior equity returns is a need for risk tolerance.

	Mth	Prev. mth	3-mth	6-mth	12-mth
MSCI ACWI	2.2%	1.1%	7.2%	13.6%	37.4%
Regions					
S&P 500	2.3%	0.7%	8.5%	15.3%	40.8%
MSCI EM	1.2%	1.4%	4.6%	9.5%	38.7%
Europe 350	1.9%	1.8%	5.7%	15.3%	29.5%
Nikkei 225	-0.1%	0.2%	-1.2%	5.8%	31.3%
Aust. Equities	2.3%	2.3%	8.3%	12.9%	27.8%
Global Sectors					
Financials	-2.2%	4.4%	6.0%	19.6%	45.3%
Industrials	-0.1%	2.5%	4.5%	14.8%	42.6%
Materials	-2.7%	2.7%	4.5%	12.1%	39.3%
Commun.	2.3%	-0.3%	8.0%	16.1%	41.2%
Energy	4.0%	4.2%	7.7%	26.7%	29.3%
Cons. Discret.	3.4%	-1.5%	5.8%	9.7%	44.9%
Technology	6.5%	-1.2%	10.3%	13.4%	45.5%
Real estate	2.1%	1.2%	8.5%	16.5%	26.7%
Health Care	3.7%	1.9%	9.3%	11.4%	22.4%
Cons. staples	0.7%	2.6%	5.5%	6.4%	18.1%
Utilities	-1.8%	-0.8%	-0.6%	1.5%	13.0%
Global Factors					
Small cap	1.2%	0.4%	4.9%	16.5%	50.3%
Value	0.0%	2.9%	5.1%	18.0%	41.5%
Quality	3.3%	1.6%	10.1%	13.7%	39.8%
Growth	4.8%	-0.5%	9.7%	11.6%	37.8%
High yield	0.3%	2.4%	4.2%	12.6%	26.3%
Low vol	1.5%	1.5%	5.2%	8.8%	18.7%

Source: Bloomberg. Past performance is not indicative of future performance.

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Long-term Asset Class Returns - 30 June 2021

	Aust. Equity	Small Caps	Intl. Equity	A-REITS	Global REITS (H)	Aust. Fixed Interest	Intl. Fixed Interest (H)	Cash	Emerging Markets	Infrastructure (H)	Commodities	#Hedge Funds
Return												
1-month	2.3%	3.1%	4.7%	5.6%	2.1%	0.7%	0.5%	0.0%	3.3%	-0.2%	0.0%	0.9%
3-month	8.3%	8.5%	9.3%	10.7%	10.0%	1.5%	0.9%	0.0%	6.6%	1.8%	9.6%	4.5%
6-month	12.9%	10.8%	16.3%	10.1%	19.2%	-1.7%	-1.6%	0.0%	10.6%	6.0%	23.4%	5.4%
1-year	27.8%	33.2%	27.5%	33.9%	33.7%	-0.8%	-0.2%	0.0%	29.6%	17.2%	36.6%	1.8%
3-year	9.6%	8.6%	14.5%	8.2%	6.2%	4.2%	4.0%	0.9%	11.1%	3.3%	1.6%	5.2%
5-year	11.2%	11.2%	14.7%	6.2%	4.9%	3.2%	2.9%	1.2%	13.2%	4.8%	3.7%	4.4%
10-year	9.3%	6.0%	14.8%	12.0%	9.5%	4.9%	5.3%	2.1%	8.4%	7.8%	-0.2%	7.6%
15-year	6.9%	4.4%	7.7%	4.0%	6.4%	5.5%	6.3%	3.2%	6.9%	6.6%	-2.0%	4.5%
20-year	8.2%	7.1%	5.1%	6.9%	10.2%	5.6%	6.5%	3.7%	8.3%	---	1.1%	3.5%
25-year	9.2%	6.5%	7.6%	8.3%	8.0%	6.2%	7.0%	4.1%	7.0%	---	---	7.3%
30-year	9.8%	7.9%	8.3%	8.6%	8.8%	7.0%	7.6%	4.5%	8.6%	---	---	---
Standard Deviation												
3-year	17.6%	21.5%	12.3%	26.2%	20.1%	3.6%	3.1%	0.2%	11.5%	18.5%	17.5%	7.4%
5-year	14.5%	17.8%	10.7%	21.7%	16.7%	3.2%	2.7%	0.2%	10.2%	15.1%	14.9%	7.4%
10-year	13.6%	16.7%	10.8%	17.5%	15.1%	3.0%	2.8%	0.3%	10.8%	12.5%	13.9%	9.5%
15-year	14.3%	19.0%	11.6%	19.8%	19.4%	3.0%	2.8%	0.6%	12.9%	13.5%	14.2%	10.7%
20-year	13.4%	17.6%	11.8%	17.6%	18.0%	3.0%	2.9%	0.6%	14.2%	---	14.3%	10.1%
25-year	13.2%	17.2%	12.3%	16.5%	17.6%	3.2%	2.9%	0.5%	16.7%	---	---	11.0%
30-year	13.3%	16.5%	12.2%	15.6%	17.4%	3.8%	3.0%	0.6%	17.1%	---	---	---

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We lead this week with a look at the noise which is distorting asset values with suggestions on how to react. There is an extreme valuation disconnect, suggesting something 'old' and 'new' is happening, where each side does not even speak the same language, never mind have different interpretations. Find out why some young fish don't even realise they are in water.

Then in our white paper section from **AMP Capital**, **Shane Oliver** suggests five ways to turn down the noise, saying it is more difficult than ever in a digital age with rapid dissemination of news and opinion.

Last week's article by former leading super consultant, **Don Ezra**, on his own retirement spending has been viewed over 12,000 times, and many readers offered their own take on not running out of money in retirement.

Tracy Li (with **Matt Reynolds**) focus on the one cloud which seems to hang over big tech companies, the threat of regulatory restrictions on their business. US **President Joe Biden** has been talking about new rules this week, and Tracy's experience in banking and the internet reveals the real risks.

Still on technology companies, **Tim Davies** gives three reasons why investors should look for weaknesses in share prices to buy, focussing more on the positives than short-term negatives.

David Knox takes a critical look at the way the Intergenerational report places a cost on superannuation. It's an important argument as influential voices seek to control the growth of super.

There is no more important sector in Australian stockmarkets than the banks, especially the Big Four, and **Tariq Chotani** picks favourites including the vital factor to watch for. Some have it, some don't.

Then **Francyne Mu** says that in her years of studying the ability of management to focus on a business, 'pure play' and 'best-in-class' companies are better at managing a range of risks than less-focussed conglomerates.

We have covered the Your Future, Your Super legislation in detail, such as here and here, including doubts about the way it works. But the legislation has received a far more optimistic interpretation in other places, such as **Jessica Irvine** in the **SMH**. She wrote:

"I ran the numbers for my super balance of about $300,000 and calculated that if I invested it in the MySuper option of the best-performing fund (and made no further contributions and the 6-year net return was replicated each year) it would be worth about $1.3 million in 20 years. If I invested in the worst fund, it would be worth only $700,000."

Wouldn't it be great if we could ask a super fund or fund manager that had done well in the previous six years to back-date our application. It's such a shame when we actually invest, we don't know which fund will do best in the only time that matters ... the future.

The **Comment of the Week** must come from my school economics teacher, **Paul Coghlan**, after my editorial on the need to give students more investing skills. Paul wrote:

"As the teacher who taught you Economics at Randwick BHS back in the mid 1970s, I offer a few observations based on teaching the discipline for almost fifty years. Before the introduction of Business Studies, Economics was the most popular Social Science of the HSC offerings. Prior to this, it became apparent at the HSC marking centre that there was an increasingly long tail of students who simply could not attain a reasonable level of economic literacy. For many students and probably some teachers, Economics had become too challenging. Rather than dumb down Economics, the new easier and more descriptive Business Studies course was offered. A fellow teacher described the new course as being "a mile wide and a foot deep". The fact that a diminishing, though more able cohort, was studying Economics, meant that it was far more favourably scaled for the UAI was sometimes overlooked by teachers advising students on course offerings in Years 11 & 12."

Don't forget our **Education Centre** which is brimming with updates on listed investments (see links below), including a new monthly report from **Chi-X.**

Investing is like water, but what the hell is water?

Graham Hand

David Foster Wallace was a brilliant American writer and satirist. In a commencement speech to Kenyon College graduates in 2005, he gave a parable about the difficulties of daily life:

"There are these two young fish swimming along, and they happen to meet an older fish swimming the other way who nods at them and says, 'Morning, boys, how's the water?'

And the two young fish swim on for a bit and then eventually one of them looks over at the other and goes, 'What the hell is water?'

... The point of the fish story is merely that the most obvious, important realities are often the ones that are the hardest to see and talk about ... A huge percentage of the stuff that I tend to be automatically certain of is, it turns out, totally wrong and deluded."

Although Wallace did not specifically speak about investing, it is equally applicable in 2021. The traditional fundamental investment analysis, such as taught to the high levels of a CFA, or Chartered Financial Analyst, uses many ways to value a company based on metrics. These include Price to Earnings (P/E) ratios, Return on Equity, Price to Book (P/B), dividend payouts, market beta, and on it goes. Combined, they help an analyst to derive an intrinsic value of a company which can be compared with the current share price.

What's the relevance of Wallace and his fish?

We are now investing with increasing disconnects between this fundamental analysis and what some players, young and old, are willing to pay for a wide range of assets. More than ever, even in the dotcom boom, we have some fish saying the water is obvious, like the intrinsic value of a company. And we have other fish who not only ignore these traditional metrics, they are not even in the same fish tank.

"What the hell is water and what the hell is intrinsic value?"

To become a CFA requires years of work and a recommended 300 hours of study per exam level. An alternative way to invest (or trade) is to follow someone who was the world's richest man a few months ago:

Memes are treading on thin ice and will go to water

The best examples of the excesses are 'meme stocks'. Even the people who buy them struggle with a definition. Apparently, you recognise them when you see them, or '*they just are*'. Urban Dictionary goes with this definition:

"Any publicly-traded company stock that keeps going up and disregards the fundamentals such as revenue and profits when valuing the underlying company ... Due to hype around the company and its future outlook, the price of their stock keeps going up beyond a point that makes logical sense which may or may not result in a steep drop later on once/if the hype dies down."

The prices are often driven by platforms such as Reddit, TikTok and Robinhood, in a social media barrage of self-reinforcing chat. If a stock is $10 today and everyone is talking about it, then it will probably be worth $15 tomorrow and $20 or $100 in a week. The best example is GameStop in the US which went from US$20 to almost US$500 in a month at the start of 2021. The surge had nothing whatsoever to do with the company's 'value'. On social media, young fish boasted of their rapid money-making and their friends drowned their FOMO by piling in. The miracle turned water to wine.

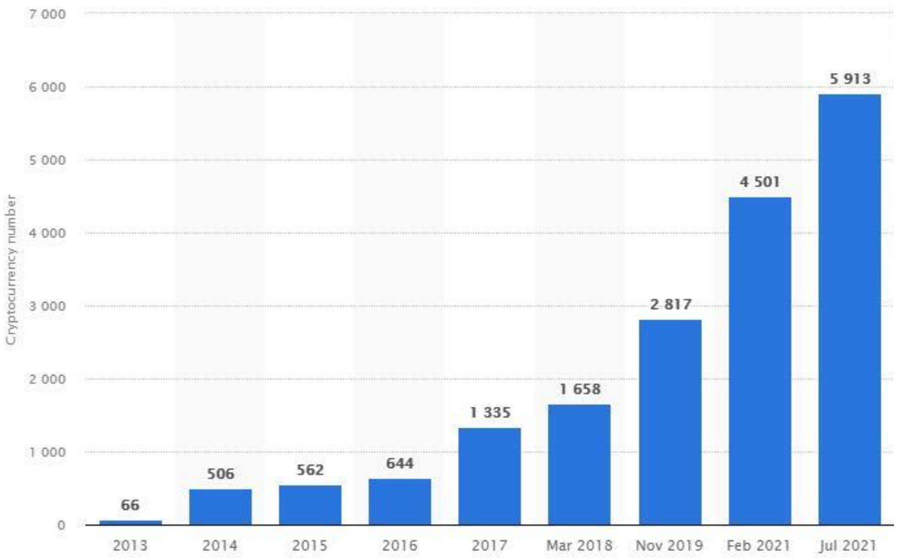
Morningstar Chief U.S. Market Strategist, David Sekera, said this about investing in memes:

"Investors should not buy into the meme mania. It should be contained within the realm of day-traders who are willing to speculate on momentum. Part of the reason Meme stocks such as these have arisen in the first place is FOMO, or Fear of Missing Out, which is fuelled by too many people touting about how much money they are making on these trades. These situations are not what we consider to be an investment but are short-term momentum trades, meaning that the stocks are not moving due to changes in the underlying fundamental value of the company but are based on technical indicators. These situations often start with a short squeeze, and then turn into a self-fulfilling prophecy in the short run on the way up. But once the upward momentum runs out and stocks start to turn down. Look out below - traders will look to exit positions as quickly as possible and will hit any and all bids on the way down until they are out of their positions."

Crypto expands beyond digital currencies

Another example is cryptocurrency. It's almost impossible to keep count of the daily increase in the number of coins and tokens as it is easy to create a new one. There are at least 6,000 with some estimates as high as 10,000. The top 20 comprise about 90% of the market, so most will crash and burn worthless. Outside of leaders Bitcoin and Ethereum, the best known is Dogecoin (the Doge reference in the Musk tweet above) which started as a meme-inspired joke in 2013. In the planned float of popular 'free' trading platform Robinhood, its initial documents reveal that 34% of its cryptocurrency-based revenue was due to Dogecoin transactions compared to only 4% in the previous quarter.

Number of cryptocurrencies worldwide 2013 to July 2021



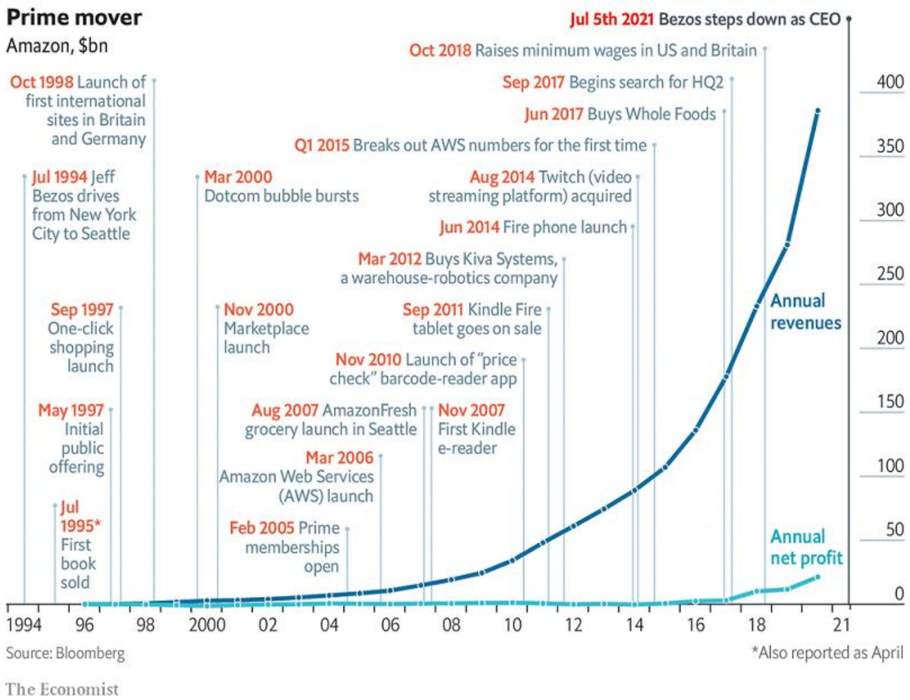
Source: Statista

With retail investors piling into new coins, and no doubt heavily supporting the IPO of Robinhood, the whole edifice is testing who knows about water. Even for Bitcoin, governments are cracking down on the massive use of electricity to mine new coins, especially in China where warehouses full of computers have been forced to close.

The Amazon is the world's largest river by volume

Of course, for every thousand crazy valuations that turn to dust, there is one that is pure liquid gold. That is why many hair-brained ideas are backed by investors. Get one right and it can pay for a lot of mistakes.

Amazon (the company, not the river) started as one of the earliest and biggest bets on the internet. For many years, analysts criticised its business model, with Jeff Bezos firmly placing growth and customer service ahead of profit. Brad Stone's book, *Jeff Bezos and The Age of Amazon (2013)* chronicles that despite the rapid growth in sales, Amazon lost around US$1 billion in the dotcom period in 2000 and barely avoided insolvency. Bezos is now the world's richest man worth around US$200 billion, having finally stepped aside as CEO last week at the age of 57.



As this chart from *The Economist* shows, profit meant little to him, a remarkable departure from the traditional emphasis on the purpose of business. Bezos might well say "*What the hell is profit!*", much to the chagrin of most of Wall Street. Amazon's P/E is currently about 70 which a fundamental analyst would call bubble-territory expensive, and it's at an all-time high and up 100% since March 2020.

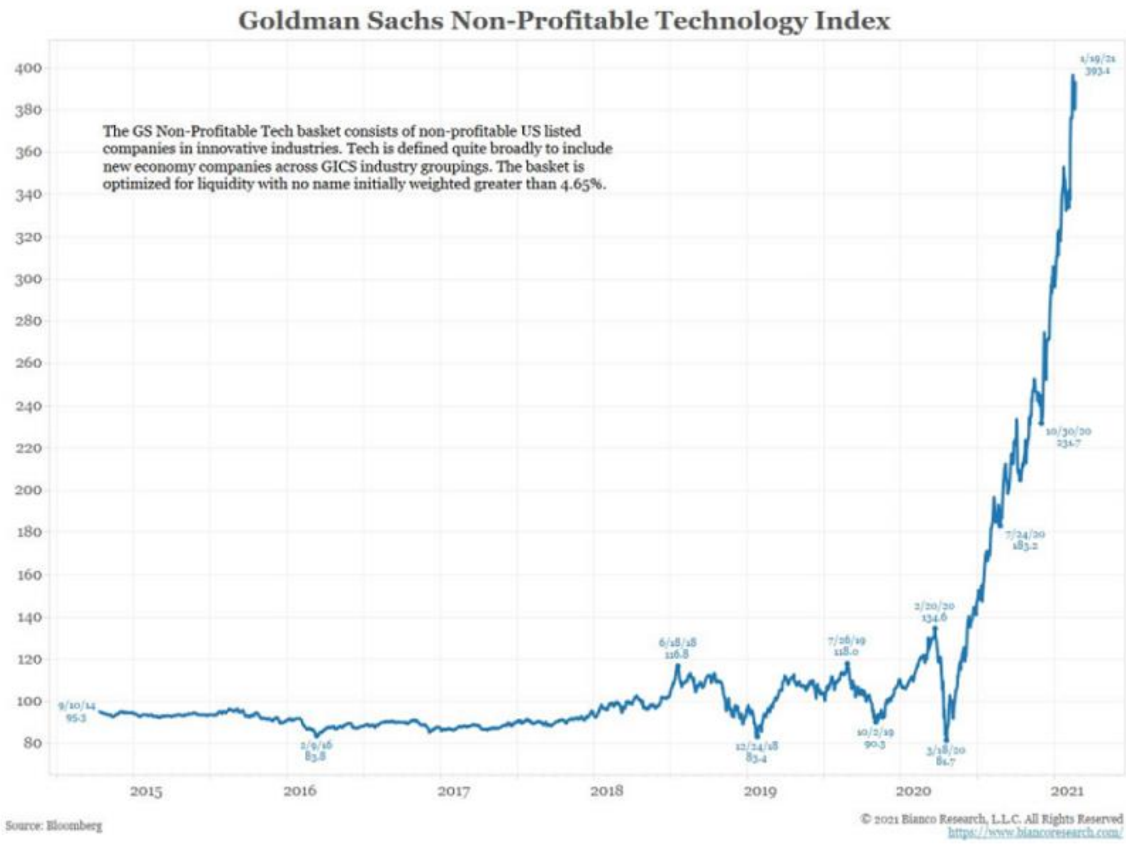
Everyone is looking for the next Amazon, and access to capital for startups has never been easier. This has no parallels in history, and as [The Economist](#) says:

" ... something astonishing is going on in fintech. Much more money is pouring into it than usual. In the second quarter of the year alone it attracted $34bn in venture-capital funding, a record, reckons CB Insights."

That's AUD45,000,000,000 in three months, just for tech startups. It's no wonder older companies are facing unprecedented tech disruption. Business has never seen so much capital available to so many smart people.

The wonderful Non-Profitable Tech Index

Goldman Sachs produces an index of listed US tech companies which are not making a profit. The chart below (from Bianco Research) shows how this index remained flat around for the period 2014 to sometime in 2020. As companies benefitted from a quick adoption of tech during COVID, the index reached a peak of 433 on 12 February 2021. It has since fallen to the current level of 328 which some might call a reality check, but who knows when to calculate a P/E, you need an E, and none of these companies have one.



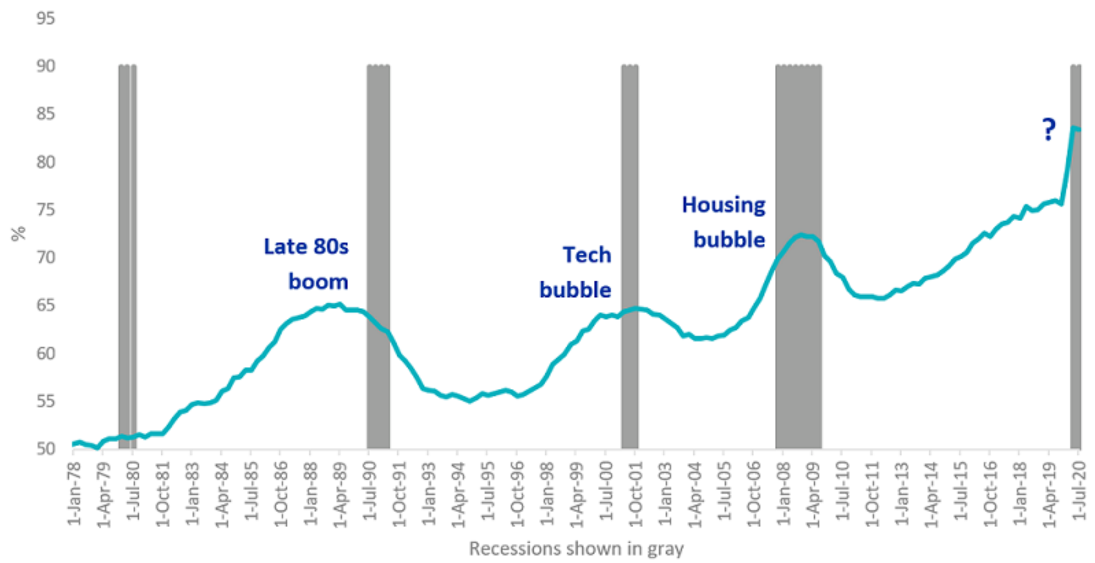
It's not only social media, it's central banks

Responsibility for these excesses go right to the top of policy making. US stimulus shows few signs of easing, with massive infrastructure spending coming. The US central bank, the Federal Reserve, now buys all net Treasury issuance and owns 25% of all US Government bonds. The yield on US Treasuries is no longer a market rate as it is effectively set by the Fed. It's hard to see a turning point as it will be many years before governments feel the need for fiscal restraint at the risk of losses in jobs and votes. There is no incentive now they realise there is indeed an unlimited water well.

And here are two charts showing the extraordinary impact. For the first time ever, the return on high-yield bonds (previously called junk bonds) is less than the inflation rate in the US. Admittedly, inflation is artificially high due to falls a year ago and some (hopefully) short-term supply problems, but it was only a year ago at the height of COVID that the margin was 10%.

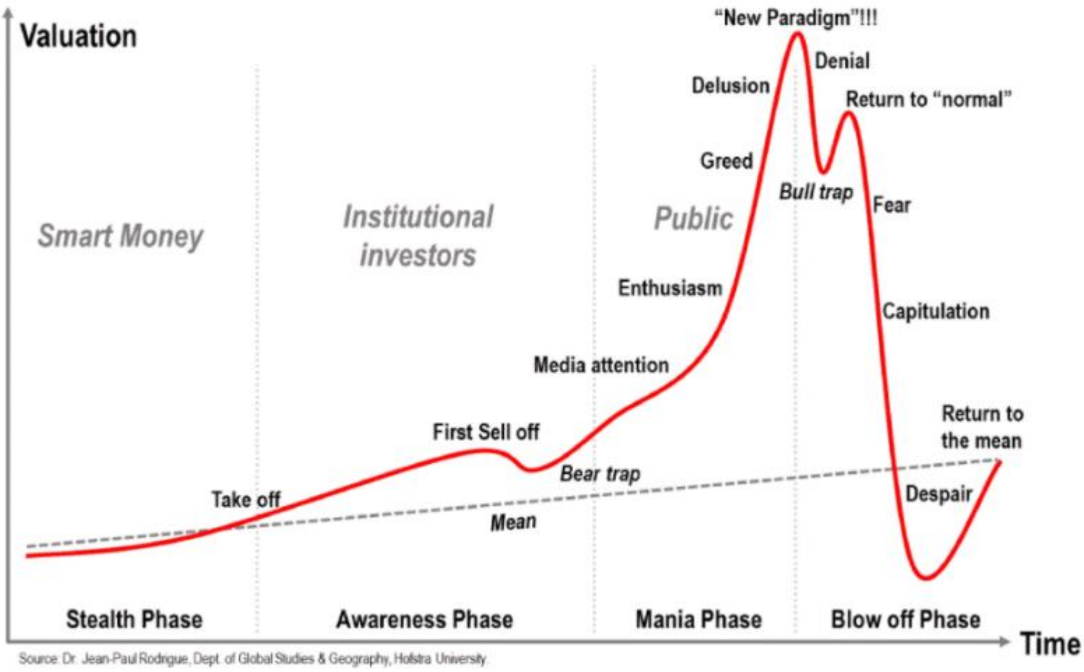
While this margin will return to a small positive soon, the record low interest rates are encouraging companies to borrow. The ratio of US corporate debt to GDP is at an all-time high. Central banks are stimulating economies and companies are borrowing, but history suggests that after similar peaks in credit, sharemarkets have struggled.

US Total Credit to Non-Financial Corporations as a % of GDP



There have always been cycles of extremes

Of course, there is nothing new about cycles and excesses. John-Paul Rodrigue famously produced the following chart on the phases of an economic bubble. The 'smart money' gets in early, and by the time the public is in full swing, greed and delusion take over. At the peak, 'This Time is Different' in the 'New Paradigm'. Many assets such as Non Fungible Tokens (NFTs) have surpassed even where Rodrigue thought his chart should go. After fear, capitulation and despair, markets return to the mean.



How should investors react?

Unable to resist a Warren Buffett quote, he said, "*Investing is easy but not simple*." Indeed. There are at least as many people who believe the FAANG stocks are seriously overvalued as there are others who think they are the greatest companies in history at value prices.

Let's return to Wallace and his speech to students:

"If you're worried that I plan to present myself here as the wise older fish explaining what water is to you younger fish, please don't be. I am not the wise old fish."

Maybe for many assets, the young fish are right. What the hell is water? Who cares if it took Amazon 20 years to make a profit? Companies in the Goldman Sachs index include Spotify, Shopify and Pinterest. Spotify is redefining how we listen to music, so who's to say what it will be worth in five years? The young fish swim on, leaping on every word from Elon Musk as if he were The Messiah.

While the water may be different in some ways, it is still there, such as:

- We don't know when rates or inflation will rise but at some time they will.
- We don't know when worthless memes will crash but they will.
- While blockchain technology and some 'electronic currency' will have a future role, most of the thousands of cryptocurrencies will expire worthless.
- Stockmarkets fall by 10-20% at least once every few years and every generation sees a 40-50% correction, and this will continue to happen.

We don't know if hell freezes over and we can't put a date on any of these events, but instead of fishing around in someone else's pool, we should prepare our own portfolios for the inevitable.

Graham Hand is Managing Editor of Firstlinks. This article is general information and does not consider the circumstances of any investor.

How to gauge three key regulatory risks facing Big Tech stocks

Matt Reynolds, Tracy Li

When it comes to America's biggest technology companies, it seems like regulatory risk has never been higher. Most large technology platforms are facing pressure from U.S. and European authorities, while lawmakers on Capitol Hill seem more inclined to do something rather than nothing.

My Capital Group colleague, Tracy Li, discusses further.

As an internet analyst, I am in the unusual position of having studied another intense regulatory cycle as a bank analyst: the Dodd-Frank legislative process in the wake of the global financial crisis. During that period, I spent many weeks on Capitol Hill meeting with key lobbyists and congressional staffers as part of my due diligence into the large U.S. banks.

Living through that experience has helped me calibrate my thinking on three key risks faced by Big Tech, which primarily fall into the categories of privacy, content and antitrust. Before I dive into those issues, I'll share how my experience as a bank analyst has influenced my views.

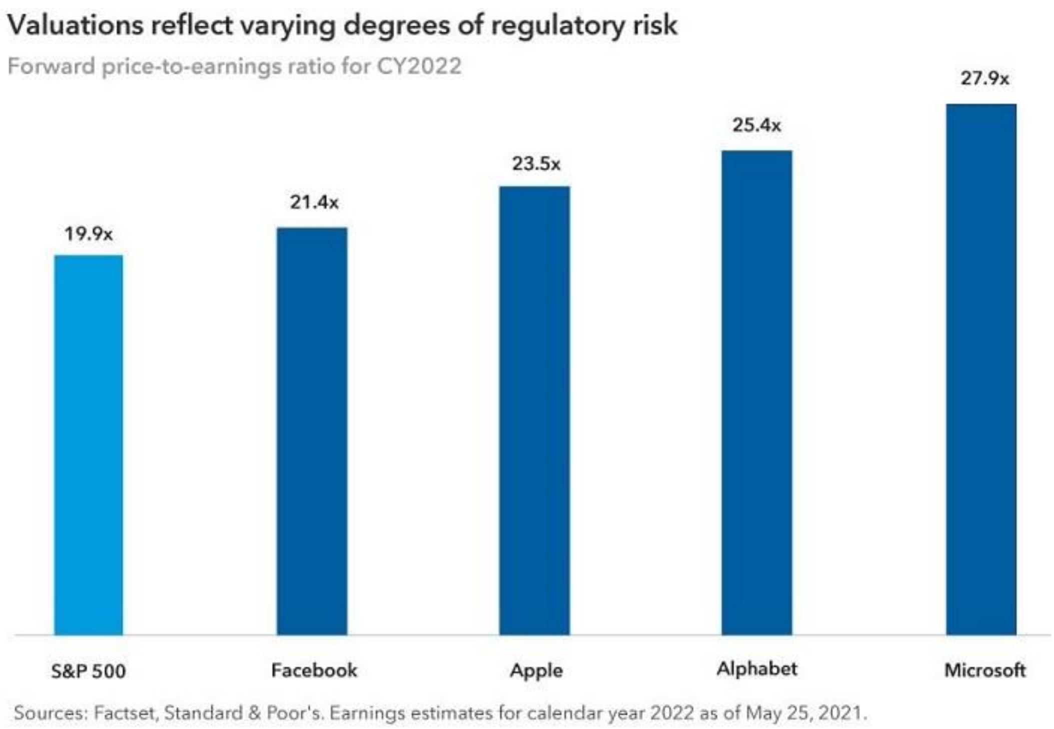
Applying lessons from Dodd-Frank to this Big Tech regulatory cycle

1. Trying to predict the exact nature of regulatory outcomes is an inexact science. In my experience, it can be very challenging to develop a research edge on predicting regulatory outcomes. In my view, investors tend to spend too much time on it. I believe it is better to spend more time trying to assess how willing and able companies are to adapt to regulatory change.

2. Companies can survive, and even thrive, following intense regulatory cycles. The Dodd-Frank Act included almost 28,000 new rules and restrictions on banks! Revenue pools were curtailed, capital requirements doubled, and compliance costs soared. At the time, some thought big banks just weren't investable. But starting in 2013, a few large bank stocks went on to significantly beat the broader market over the rest of the decade.

3. Regulatory adaptation is a powerful and often underestimated force that separates winners and losers. In the years following the passage of Dodd-Frank, banks adapted to regulation. They restructured, changed their business mix, became more efficient, learned to optimize capital and developed new competitive edges in areas of technology and marketing.

4. Starting valuations matter a lot. A big reason that big bank stocks had such a great run after Dodd-Frank was their low starting valuations. In my view, among the large U.S. tech companies Alphabet and Facebook are already pricing in a typical regulatory shock, based on past studies of other industries that faced such pressures. These tech giants also trade at cheaper valuations than Visa and Mastercard, both of which I consider to be high-quality companies with wide competitive moats and pricing power.



5. Politics often prevails more than economic logic in policymaking. I believe there are many examples in banking regulation of irrational policies and unintended consequences. For example, regulators realized that the SLR (supplementary leverage ratio) rule for big banks did not quite work as intended, but it took more than a

decade and the risk of a deep recession to recalibrate it. (The rule stipulated the amount of common equity capital banks must hold relative to their total leverage exposure.)

Big Tech faces three regulatory risks: Privacy, content and antitrust

When I look at the major regulatory risks faced by technology companies today, they fall in three broad categories: privacy and data protections, content monitoring, and moderation and antitrust action.

I believe that concerns related to privacy or content may actually strengthen, rather than weaken, the moats of the largest platforms. These companies often boast well-established protocols and have more resources to tackle privacy and legal matters. I'll briefly address each of them here.

Privacy: This is a nuanced issue with lots of trade-offs, so legislation will be slow. Companies will do more to regulate each other and themselves, while regulation plays catch up.

What's often missed in the headlines is that the privacy and data transparency restrictions enacted by companies have the potential to be more disruptive to the industry than governmental regulation. IDFA (Identifier for Advertisers) is a recent example, with Apple making changes to its operating system. The ad-tech industry relies heavily on individual data in the form of IDFA user data from Apple and third-party cookies to serve targeted advertisements. Google also plans to phase out third-party cookies on its Chrome internet browser.

Ultimately, competitive advantages will likely accrue to companies that have access to first-party data, or data collected on their proprietary platforms or ecosystems. Companies with capabilities in artificial intelligence and machine learning such as Google and Facebook might also be at an advantage.

What's more, the regulatory landscape will likely become increasingly complex as more governments institute data privacy regulations. Therefore, I think that recent laws in Europe and the U.S. may have the unintended consequence of supporting the largest companies in the industry over their smaller rivals.

Content: By way of example, there's been plenty of debate about Section 230 in Washington, and I think it will most likely not be repealed but reformed.

Section 230 was enacted in the US as part of the Communications Decency Act of 1996. It provides limited federal immunity to providers and users of interactive computer services. To date, internet companies have largely been shielded from the content posted on their platforms.

I anticipate bipartisan consensus will build around requiring internet platforms to increase transparency and reporting on content governance—and remove content within 24 hours if ordered by a court. This means compliance costs may rise and fines could be more frequent, but these rising costs will also widen the competitive moats for the biggest companies.

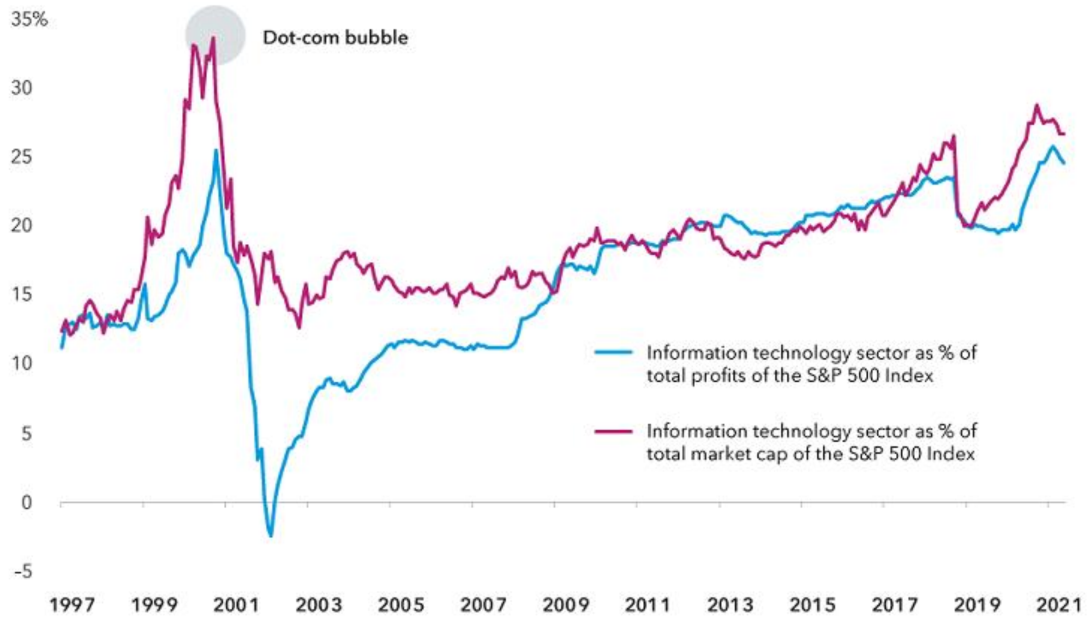
Antitrust: Going back to my Big Bank analogy, one big difference between the two regulatory cycles is that antitrust is a much bigger focus for the internet companies. Perhaps anticompetition for the big internet platforms now is what "safety and soundness" was for the big banks? It's the most important systemic problem regulators see.

Therefore, similar to the "too big to fail" framework for banks, we may see a framework implemented for internet platforms where differentiated anticompetition rules are applied based on size.

I don't see any significant breakups of companies, but I think future M&A will become much harder to do on a meaningful scale. The House investigations into the 'monopoly power' of Apple, Amazon, Google and Facebook exemplify closer scrutiny of future deal-making.

In one example of how difficult it can be to prosecute antitrust cases, a federal judge on June 28 dismissed antitrust lawsuits brought against Facebook by the Federal Trade Commission and dozens of state attorneys general. The judge said the FTC's lawsuit did not support allegations that Facebook had gained monopoly status in the social media industry. It remains to be seen whether the FTC will amend its suit and refile.

US Tech companies have built profitable franchises since the dot-com bubble



Sources: FactSet, Standard & Poor's. As of April 30, 2021.

As with most governmental or regulatory actions, it is important to remember that the first report or first version of a bill is almost never the exact text of the final regulation or law. It is very likely that any changes to antitrust law will look very different from the proposed bills.

Likewise, antitrust cases more often end in settlements or fines rather than the breakup of a company. The big companies may in the meantime work to mitigate any potential impact and self-regulate.

It's worth noting that past M&A activity has allowed many smaller companies to grow and mature under the umbrella of the big parent companies.

For example, Facebook's messaging service WhatsApp has more than two billion average monthly users in 180 countries yet provides only a fraction of the firm's revenue. Alphabet derives the majority of its revenue and earnings from advertising; meanwhile, its autonomous driving unit Waymo and health sciences division Verily have essentially no revenues. But these technologies of the future might be worth billions of dollars to investors as stand-alone enterprises. This may make the companies attractive investments regardless of future regulatory actions, based on the secular growth of the industries in which they operate.

Conclusion

The major technology and internet platforms face a number of challenges ranging from privacy issues and content moderation to antitrust and regulatory pressures. However, I believe that concerns related to privacy or content may actually strengthen, rather than weaken, the moats of the largest platforms since these companies often boast well-established protocols and deep resources pertaining to privacy and legal matters.

Furthermore, regulatory outcomes are difficult to accurately predict and often less important to determining company success than factors related to the business itself, particularly adaptability of the management, ability to develop new innovative products and services, and current valuations. By focusing on these metrics and closely monitoring legal and regulatory developments, it is possible to find attractive investment opportunities in the companies facing these pressures.

Tracy Li is an Investment Analyst at Capital Group and Matt Reynolds is an Investment Director for Capital Group Australia, a sponsor of Firstlinks. This article contains general information only and does not consider the circumstances of any investor. Please seek financial advice before acting on any investment as market circumstances can change.

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Among key trends in Australian banks, one factor stands out

Tariq Chotani

Australia's major banks make up a large chunk of the ASX and are a key component of most investors' portfolios. Following the Big Four reporting half-yearly or quarterly results, it is an opportune time to reflect on the sector and some of the key trends.

Main takeaways from the Big Four banks' results

Bad debts were less of a factor than we expected on the back of a positive economic outlook thanks to the amount of money that's been thrown at the economy by the central bank and the Federal Government. The large chunk of loans that went into deferral have now rolled off deferral and borrowers are back into the habit of paying down their debt. About 10% of mortgage holders were not paying anything, not paying down the debt or paying their mortgage for about four to six months.

From an asset quality perspective, the market was expecting a good outcome and it came through better than expected. On the operational part, the market seems to be shifting back to analysing the top line on revenues and credit growth, which is not growing as quickly as analysts thought. On a net basis we are still seeing anaemic credit growth from households and while business lending has shown some signs of improvement, we still need to see how that flows through over the next three to six months.

Those are the broad trends. Some banks are spending smartly because they know how to and some banks are hoping that they are on the right track to reach a sustainable level in the next three to five years.

Resilience of the banking sector

The COVID pandemic and associated business disruption was a massive stress test of the Australian banking system. Thankfully, the Australian banks were already in decent shape going into COVID-19. Regulators in both Australia and New Zealand were proactive from the start and have been conservative, relative to global peers, in the way they calculate capital.

Commentators may argue that the major banks benefitted versus the non-major banks because of low risk weights for mortgage books, but there was undoubtedly a considerable amount of capital in the system before COVID. It helped that this occurred after the Royal Commission where the issue of 'unquestionably strong' levels of capital was front and centre.

APRA had set the tone and the phenomenal Federal Government and RBA response was also extremely helpful to the banks, which reciprocated with deferral programs, so it's been a team effort. Assuming we stay on top of COVID (and the latest Sydney outbreak is a threat), we may be better off than we expected 12 to 18 months ago.

By our estimates, each of the major banks is sitting on between $7 and $10 billion worth of capital that can be distributed back to shareholders. So far, the banks in general have behaved rationally and have managed margins and returns. We expect capital return and capital distribution to be the key narrative over the next six to nine months.

The impact of neobanks and insurtechs

Pre-COVID, one of the big themes for the banks was digital disruption in the form of tech-savvy competitors moving into the financial services sector or overseas neobanks appealing to tech-savvy consumers in Australia.

I'm more sceptical of the neobanks and insurtechs than some of the other participants in the market. They need to get scale quickly. They need to reduce the cost of acquisition of a customer and they need a steady-state capacity level, which can drive operating leverage.

It is great that disruptors are offering a seamless customer experience but it's very generic and it is a commoditised offering on savings. Having said that, we've seen some interesting offerings like Bendigo and Adelaide Bank's digital bank, UP, and the user experience from Athena. We've seen 86,400 Ltd (now part of NAB) which also had a strong offering but they could not reach scale. Xinja was another big hope that went out hard with their rate offering to entice new customers, but they were unable to sustain their push into the market.

The theory of neobanks is good and they keep the incumbents honest and there are some incumbents who just will not spend money on technology. Westpac is spending on the front end but needs its back end in order. ANZ was lagging in technology and their app experience but now they're spending money. Bank of Queensland will hopefully have a contemporary banking app soon. I think it's fair to say that the incumbents tend to get lazy.

I agree with CBA's CEO Matt Comyn's comments at the recent Senate hearings that a number of technology providers are deliberately trying to build capability without an ability to scale or with a viable business model, but they may accelerate innovation if it were scaled. A lot of disruptor business models are predicated on getting taken out by the big players.

My investment logic for holding Big Four bank shares

Analysing large companies can be a joy and a pain but it is rarely boring. Narratives are increasingly important for the markets and with large companies it is critical to get ahead of some of potential shifts in narratives. There was a point when the Big Four were really cheap in the midst of COVID. It doesn't mean that they were riskless, but on a risk reward basis, with all the support offered by governments, the probability of banks struggling was low.

While the four majors have different strengths and operating divisions, all of them except Westpac are now a lot simpler than they used to be. Westpac still has specialist businesses that it needs to get rid of. CBA has sold its insurance businesses. ANZ doesn't have a wealth or a life business anymore. NAB's a pure bank now, it doesn't have a UK bank and it doesn't have MLC or a life business.

They're much cleaner, core banking businesses but they are still large and complex. And it's not just loans, they're dealing with people and their lives and their assets and their businesses. More than ever, franchise value is tied to how the market and how consumers perceive these brands.

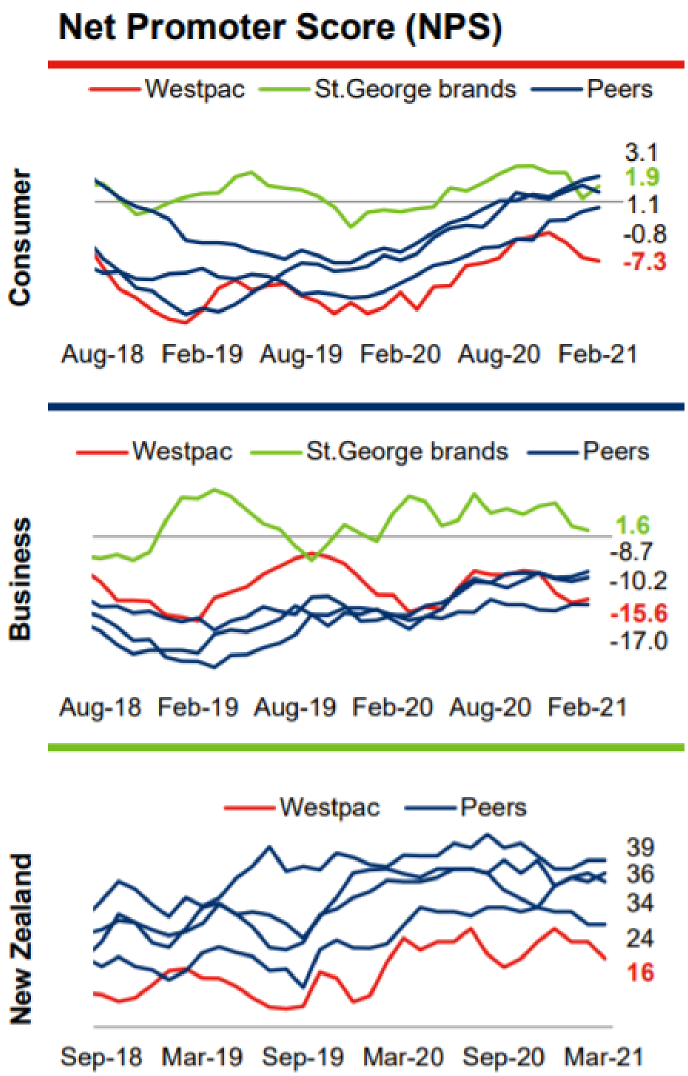
Current take on the Big Four

NAB and CBA exhibit strong core themes that I want to see in a bank to capitalise on an improving environment. They exhibit the best franchise momentum for revenues and for volumes. NAB has managed its costs quite well while CBA, historically, has not cared as much about costs because it always grew its top line faster than costs. But this also offers CBA the biggest opportunity if it gets serious about taking costs out.

Both banks are sitting on extremely healthy levels of capital, so if they see the opportunity to drive hard for growth, they don't have to worry about a lack of capital. So franchise momentum is critical at this juncture.

ANZ has seen its mortgage loan momentum slow, but it's also a much simpler bank under Shayne Elliott than it was six or seven years ago. I believe that ANZ has shown the most consistent discipline on costs compared to its local peers. The key is top-line momentum and that is a watching brief to see if ANZ can stabilise and turn that around.

Westpac is the one that scares me, and I don't use those words lightly. There's a really important chart in Westpac's most recent result presentation. It shows Net Promoter Score



Source: *Westpac 2021 Interim Financial Results Presentation* momentum for Westpac and the St George brands versus the major peers in the market. It is extremely poor and, for me, that's a key issue at this point of time.

Westpac's cost strategy means it needs to get leaner quickly, because its competitors are not standing still. It must take costs out at a core level by about 16% over the next three-and-a-half years, while at the same time stabilising the overall business. A multi-year 16% cost reduction doesn't come without cutting people.

So, how does Westpac manage the internal dynamics? Few companies can expect to cut people or rationalise costs while maintaining a motivated workforce to drive top-line growth. Westpac has shown some encouraging signs that their mortgage book is stabilising, but there are issues with the business bank. It is a complex business with many moving parts.

I think about the banks as a cohort in terms of the portfolio. Do I want to own banks at this point in the cycle? Yes. The banks I want to own depend on their franchise momentum, at least for the near term.

Tariq Chotani is an Equities Analyst at [Perpetual Investment Management](), a sponsor of Firstlinks. This article contains general information only and is not intended to provide you with financial advice or consider your objectives, financial situation or needs.

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How the Intergenerational Report misleads on super

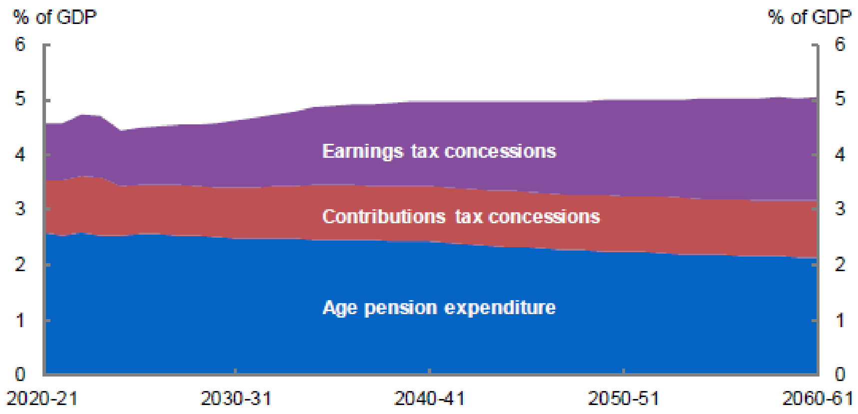
David Knox

The latest Intergenerational Report (IGR) has reignited the debate about the value of the current superannuation tax concessions by projecting that the cost will rise from 2% of GDP in 2020-21 to 2.9% in 2060-61.

In contrast, the costs of the age and service pensions are projected to fall from 2.7% of GDP in 2020-21 to 2.1% in 2060-61.

In other words, the tax concessions will be worth more than the cost of the pensions, as shown in the following chart from the IGR. This finding is not new as the recent Retirement Income Review found that by 2047, the cost of superannuation tax concessions is projected to be greater than the cost of the age pension as a percentage of GDP.

Chart 7.4.6 Cost of the retirement income system



Note: Includes service pensioners. For further information, see the Appendix.
Source: Treasury.

The IGR raises the valid question as to whether the current superannuation concessions are worth it.

Direct cost versus estimate

Before answering that question, let's recognise that in comparing the pension costs and the tax concessions we are really comparing apples and oranges. Let me explain.

The age and service pensions paid to some Australians each year are a direct cost to the federal budget, in the same way as health and education costs represent a direct expenditure.

In contrast, the super tax concessions are estimates as they do not represent a direct cost to the budget. Rather, less taxation is collected due to the concessions. The two major concessions are in respect of:

1. Concessional contributions, including the Superannuation Guarantee (SG), where the tax paid by most Australian workers is about 15% less than their marginal tax rate.
2. Investment earnings received by the super fund where the tax rate is 15% in the accumulation phase and zero in the pension phase.

The value of the super tax concessions estimate the tax forgone as a result of these concessions. It compares the tax actually paid with the tax that would have been paid if both the concessional contributions and the investment earnings were taxed at each individual's marginal tax rate.

This approach is reasonable when estimating the value of the concessions for this year. However it is unreasonable to use this approach for future years as:

- It does not allow for the reduced investment earnings if the concessional contributions and investment earnings were to be fully taxed.
- It ignores any behaviour change that would occur if the tax concessions did not exist. As the Retirement Income Review noted, individuals may choose alternative savings vehicles. The Review calculated that at the end of four years, the earnings estimate is 14% lower because the earnings on these alternative tax-preferred vehicles are subject to lower marginal tax rates than those used in the original estimate. One can only estimate what the difference would be over decades.

Hence, pension costs are known but super tax concessions are based on a series of assumptions and benchmarks, which may be debated. The value of the concessions does not equate to future revenue gain if the current concessions were abolished.

An investment in the future

Another important difference, is that the super tax concessions are about the future. In effect, it represents the government making a contribution or investment today for the future. As we invest in education for the benefit of our future society, so it is with superannuation. Employers, individuals and governments invest money today for the benefit of both future retirees and future taxpayers.

While the benefit for future retirees may be obvious, the benefit to future taxpayers is equally important. As noted above, the cost of the age and service Pensions is reducing, when expressed as a percentage of GDP, even though we have an ageing population. As the IGR noted,

"As younger generations retire with greater superannuation savings, the total proportion of older Australians receiving the age pension will continue to decline."

Indeed, a Senate Committee has previously recommended that this future saving should be calculated but this has never been completed.

The age pension costs and super tax concessions represent two very different forms of government support for our retirement income system. As Treasury notes, the value of super tax concessions "*are not estimates of the revenue increase if a variation to the tax benchmark were to be removed.*" Adding these estimates of an uncertain cost with a known cost of the current pensions is both unhelpful and misleading.

Finally, it should be noted that regardless of how the cost is calculated, the government's financial support of the overall retirement income system does not exceed 5% of GDP for the next 40 years. That is financially sustainable as this figure is approximately half the average projected level of public expenditure on pensions for OECD countries in 2050. We are indeed well placed.

Let's recognise that both the age pension and superannuation tax concessions represent important elements within our retirement income system. Let's have some stability by not subjecting either to significant change in the forthcoming years which will also improve community confidence in the overall system.

Dr David Knox is a Senior Partner at Mercer. See www.mercer.com.au. This article is general information and not investment advice, and does not consider the circumstances of any person.

Selected reader comments on retirement spending article

Firstlinks

The article by former leading superannuation consultant, Don Ezra, on his calculations on how much to spend in his own retirement attracted great reader interest and so far has been viewed over 12,000 times.

Many readers have done similar calculations for their retirement, and their experiences and learnings are worth sharing. We reproduce selected comments on how not to run out of money (with minor editing).

Goronwy

I think you are over thinking. Invest in well run companies (wealth creators) and the rest will take care of itself. That has been my approach and as a result my SMSF is worth a lot more than when I went into pension phase. If you want some personal cash safety to ride out periods of low stock prices I think a large overdraft facility secured against the house is a good idea, but the main question is what you buy not the percentage allotments of risk.

Mary

SMSF commenced 2000 invested 100% equities. Imputed credits have offset mandated withdrawals and growth has ensured capital has not declined. Am in my 92nd year and capital is the same as in 2000 although purchasing power has declined.

Steve

Heartened to see my much less analytical approach looks about right. I am working on a 5% of total assets (in and outside super) as an annual budget and around 5+ years of cash reserves. I currently have more like 8 years of cash (more if I allow for cash generated via dividends etc) but am not sure if now is the best time to add more to my growth assets (currently 60/40 growth/defensive with a 75/25 target; the 60/40 mix has about 8% historical return and the 75/25 around 10%). As the current mix is still providing >5% return hence not drawing down capital, I have some reserves to add to the market if there's a fall. Intending to revisit the plan every three years and adjust.

John

Thank you Don for your very enlightening article. It has convinced me that I have taken an excessively conservative approach with our SMSF, so it's time to take a bit more risk.

(My reply to John: Hi John, not offering any investment advice but markets are expensive and Don's article is about positioning for the long term. Portfolio adjustments are best done gradually towards a goal, and living with the short-term volatility).

Jon Kalkman

"Because we’re always withdrawing money, our assets decline over time. So if we have poor returns early, there won’t be enough of a base to make up the losses even if the later returns become above average. So we need to be able to make withdrawals without affecting the shortfall too much."

With this one paragraph, Don has described the problem that I have with institutional super funds funding my retirement that I do not have with our SMSF.

It is possible to structure an SMSF so that that the pension withdrawal is paid from income produced by the fund, not by selling assets.

In an institutional fund I buy assets (units in the fund) with my super contributions in accumulation phase. In pension phase, each pension withdrawal is paid by the sale of some units in the fund. Once sold, these units cannot be replaced as a pension fund cannot accept any more contributions. The number of units sold depends on the unit price and the process continues until all units are sold and the pension expires. Selling assets into a falling market (think GST or COVID) simply hastens the day when the pension stops. Selling assets to fund a retirement raises the critical question: “Will I expire before my assets do?”

It makes sense to take pension withdrawals from a non-volatile bucket such as cash but this is only a temporary solution because assets still need to be sold when the cash bucket needs to be replenished. It is just that in timing such a sale, it may be possible to avoid a market downturn.

With an SMSF, the pension withdrawal is paid from income produced by the fund, not by selling assets. A cash buffer is still needed to cover any unexpected shortfall in income. It means the fund is less concerned with market volatility and that means the asset allocation can be tilted towards growth assets and higher returns.

As this strategy provides adequate income now, and in the future, this could continue indefinitely if it wasn't for the mandatory pensions that increase with age. In time, some assets will need to be sold to pay these large pensions but it does not mean that the capital is lost. It simply means that this capital must be removed from the tax-concessional area of a super pension fund. It can therefore be reinvested outside super to continue to produce income - albeit in a less attractive tax environment.

Stephen

Jon, you make some valid points about the issues with unitised investments that reinvest dividends/distributions. A similar "income drawdown from dividends/distributions plus cash bucket" strategy can be put in place in Industry and retail structures via a Self Managed option. You swap some flexibility (some percentage of assets may have to be held in the Industry fund's options and there may be restrictions on ETF's, funds and shares) and possibly lower brokerage costs for less admin as the "back end" is all handled by the fund.

Outside super you could employ this strategy "income drawdown from dividends/distributions plus cash bucket" losing some flexibility but leaving the "back end" to fund.

Jon Kalkman

In an institutional fund there are certain advantages because you are not the trustee.

The "Self-invest" option is just one of the investment options you can choose. You can allocate your money among other managed options as your needs change and that may be attractive as you get older. There is also no more compliance paperwork such as the audit or tax return.

But there are also disadvantages because you are not the trustee.

The fund trustee owns the shares, not the member. These "shares" can be sold without your knowledge or consent. The member does not automatically benefit from share ownership, eg. share buybacks.

The "dividend" is paid to your account by the Fund, not the share registry. Any franking credit refund is paid to your account by the Fund, not the ATO. Your pension must be paid from a managed option, not from your "dividends". These arrangements depend on fund policy, not legislation and are easily changed.

The fund provides no advice on your asset allocation to equities. In fact, you are charged extra to use you own broker. The fund accepts no responsibility for your investment outcomes. Clearly, they prefer to have your money in their managed options because that generates their fees.

Mart

Jon - really good points, thank you ! That said, some institutional funds allow you to 100% 'DIY' (individual shares, LICs, ETFs if you wish) these days (in their 'member direct' offers)

Rob

Although many of the principles are similar, the Australian retirement landscape is a little different in that:

- income and capital gains are tax free
- mandated minimum drawdowns as you age

I agree the old 60/40 equities/bond split is a bit academic as is the mantra that the "% in Bonds should equal your age". Somewhere between 2 and 4 years living expenses in Cash/Bonds seems about right to weather most storms, so it then becomes an Asset Allocation decision!

Given the tax free status in pension mode in Oz, it does not really matter if you chase income or you realise capital gains when required. What I am seeing amongst a number of retirees in their mid 70's and 80's with reasonable balances of $1m or more, where they are "forced" to drawdown 6% or 7% of their Super Funds each year, it is often "more" than they need. While it may forcibly "come out" of Super, dependent on their other investments, it may still be invested, effectively, tax free, with any income under the income tax thresholds. Not all bad!

Irene

Hi Rob, from 65 - 74 years old, we compulsory to withdraw 5%. Then from 75 is 6% etc. I think it is fair, because all the income or capital gain in our pension fund (which changed to allocation) are tax free. Government aim self fund retiree to spend their money. If you do not need 6% and 7% to live on, you still can invest outside the super. Yes, pay tax if you make profit or have distribution.

Stevo

Spot on! If you have the assets to do so, set aside up to 5 years cash as a buffer to live on if markets have a major correction, and then actively invest the rest. Just by increasing the amount in active growth and income investments early on, you increase your overall pot SO MUCH MORE than the traditional ultra conservative approach. In Australia, with franked dividends and tax free pension earnings, you may find your pot grows much faster than you can draw it down. You should be able to generate in excess of the 5%, 6% etc. mandated annual withdrawal. And as the pot grows, the amount you withdraw also goes up - and you can put aside outside of super, what you don't spend to splash!

A fixed percentage in conservative investments doesn't make sense if you have substantial balance to start with - just work out what you will need and invest the rest.

Tony

The safety amount should factor in annual income from investments (or at least a portion of annual investment income for safety reasons) as this is cash available each year. When this is done, it will increase the % in growth investments.

John De Ravin

I agree with Tony's comment. In Australia for example, due to our tax regime, companies pay quite high dividends- they probably average out to 4% to 5% inclusive of imputation tax credits. It's true that dividends fall when the market tanks, but by proportionately less than the fall in market values. The dividend stream has a big impact on the size of the cash bucket that you need to maintain.

Dudley

The "real" problem is that the only attractive longevity insurance of relevance to most retirees is the capital and risk free Age Pension.

Fortunately, it is about 2 x the cost of living for home owners.

Thus investments need only furnish the cost of entertainment and a capital buffer (the full Age Pension Asset Test $401,500).

From a fund invested in risk free assets yielding real 0%, to withdraw for 30 years $37,000 / y to equal the capital and risk free Age Pension requires initial capital deposited into the fund of:

= PV(0%, 30, 37000, 401500, 0)
= $1,511,500

These are general comments from readers, not personal investment advice. Don Ezra says he will follow up with another article to address some of this feedback.

Best-in-class, 'pure-play' companies give clearer focus

Francyne Mu

Growth stocks have driven global equity markets higher over the past few years, but greater volatility in early 2021 may suggest that growth investors face a more challenging environment ahead. Successful growth investing will require greater selectivity to deliver attractive risk adjusted returns over the market cycle.

Competitive advantages and long-term growth trends

A deep understanding of what drives a company's business and its markets is crucial to long-term success as a growth investor. We look for high-quality growth companies that have both the technological and operational prowess to build lasting competitive advantages. The businesses should benefit from long-term secular growth trends such as e-commerce adoption, vehicle electrification, cloud computing, and financial technology.

Businesses in such growing markets tend to be dynamic, always adapting to the needs of their customers and innovating to bring new technologies and services to market. We have found that investing in either best-in-class 'pure-play' companies, or those that operate in a small number of complementary businesses, is one way to stay ahead of changes in the business and the broader industry.

Unlike conglomerates, these focused companies offer growth investors the following three significant advantages:

1. Deeper analysis of dynamic, fast-growing underlying markets
2. Focused capital allocation
3. A clear understanding of company-level economic exposures that can help with portfolio risk management.

Three examples of these insights

1. Deeper industry analysis: Intuitive Surgical vs Medtronic

The trend towards robotic-assisted minimally-invasive surgery is one place where a pure-play company can provide investors a deeper understanding of market dynamics than a more sprawling enterprise. We expect the penetration of robotic surgeries will increase over time, with worldwide procedures to grow from 2% to ~15% of surgeries over the next decade to ~US$18 billion (sourced from Goldman Sachs, Company Data).

Source: Intuitive Surgical

Intuitive Surgical Inc. is a US-based company that pioneered the robotic systems used in minimally invasive surgical procedures. Its da Vinci surgical system strives to make surgery more effective and less invasive, while also improving patients' recovery times. The company currently has about 90% of an ever-expanding market as more types of surgeries are approved to be performed with the system.

Given its dominant position, Intuitive Surgical can provide investors with a better understanding of the trends in surgical systems than many of its competitors, such as Medtronic PLC.

Medtronic is a medical device conglomerate. Their robot-assisted surgical system remains under development and the division in which this product is being developed also includes several other surgical tools. Given the diversity of its product portfolio, analysing Medtronic may not give investors a clear picture of the trends at play in the specialised robot-assisted surgical market.

Additionally, within Medtronic, it can be difficult to assess which products and systems are being prioritised with research spending, and even then, this may change significantly over time. At Intuitive Surgical, by contrast, all its research and development efforts go into improving and expanding the capabilities of the da Vinci system which can further widen its lead over competitors.

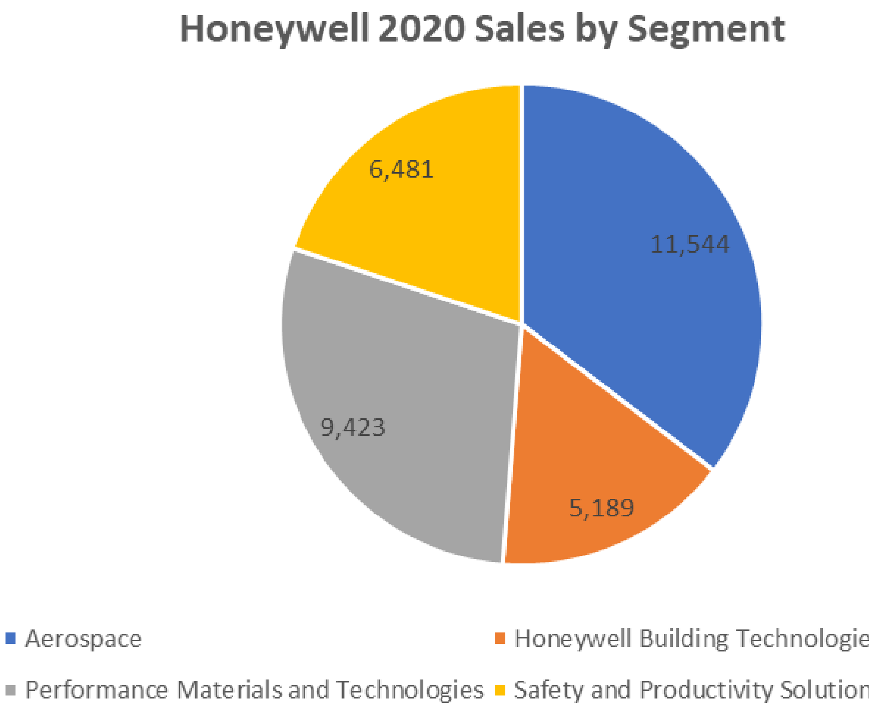
In a growing, highly technical field such as robotic assisted surgery, changes in manufacturing, intellectual property, and the regulatory landscape can make large differences in relative market-share and future profitability potential.

To accurately analyze the competitive position of our portfolio with respect to this attractive market, we value Intuitive Surgical' s direct exposure and market-leading position.

2. Focused capital allocation: Zebra Technologies vs Honeywell

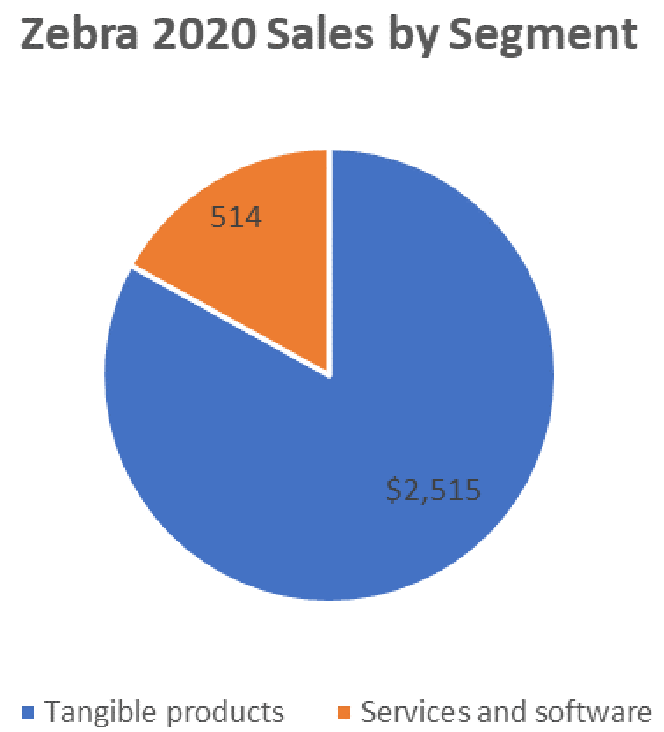
Capital allocation is also often more efficient and better understood in pure-play companies than in conglomerates. For example, Zebra Technologies Corp. which makes barcode printers and scanners to help companies manage their inventories and assets, can more efficiently and effectively allocate capital than its largest competitor Honeywell International Inc.

Honeywell is a conglomerate, with business lines that span aerospace, building technologies, performance materials, and safety and productivity solutions. While Honeywell competes in the barcode scanner space, the division makes up just 5% of total revenue. It is inevitable that a company with such diverse operations, politics and persuasion may lead management to stray from the most efficient capital allocation strategy and potentially underinvest in attractive growth opportunities.



Source: Franklin Templeton, Honeywell Company Filings, 2020

Zebra's management, by contrast, is focused on its one business, allowing it to be more effective, strategic, and proactive in real-time, by our analysis. A real-world consequence of this advantage was Zebra's introduction of a mobile device based on the Android operating system, which has now become the industry standard. Competitors like Honeywell have struggled to get customers to switch to their later entries.



Source: Company reports.

A management team concentrating on one business gives us greater confidence in Zebra's ability to remain nimble to take advantage of new market opportunities that arise in its dynamic industry.

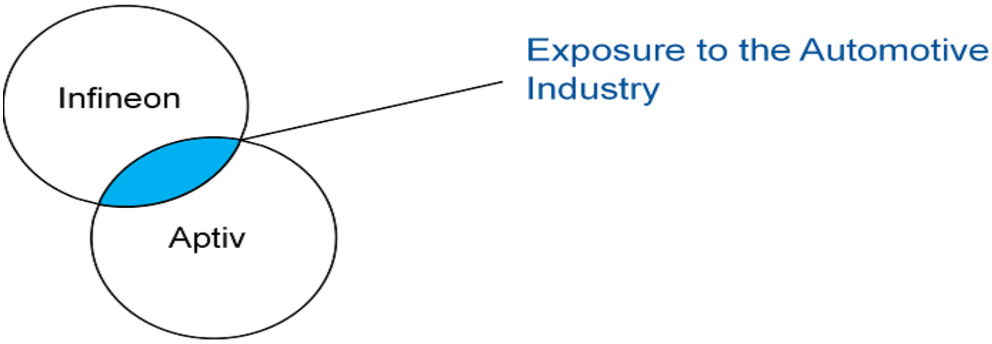
3. Improved risk management: Aptiv PLC vs Infineon

Best-in-class companies with focused business models allow us to better understand risk at the portfolio level, particularly given our focus on building a concentrated growth portfolio that is still highly diversified.

In a 40-stock portfolio, for instance, understanding where potential investments may share a source of revenue or have similar expenses is critical in ensuring the portfolio is diversified. Since growth businesses often change over time, being able to keep ahead of these changes can help avoid instances where companies that once had little overlap begin to see greater exposure to a common market.

For instance, on the surface, Germany-based semiconductor manufacturer Infineon Technologies AG might not appear to have much in common with global auto parts manufacturer Aptiv PLC. But as cars and auto components have become more sophisticated and as the number of chips powering these systems have increased, Infineon's business increasingly overlapped with Aptiv, given their exposure to auto production.

Two Sectors, One End-Market Exposure



Our experience has been that changes such as this can be more evident in companies that operate a single business or set of highly complementary businesses.

Concentrating on the long term

The universe of growth stocks is large and diverse and finding opportunities that can outperform across a market cycle is challenging. Our experience as growth managers has reinforced our view that a focus on pure-play companies can help to build a concentrated, yet still highly diversified portfolio of best-in-class growth stocks. Often this can lead us down the market cap spectrum toward lesser-known names, however we also believe that there are plenty of large cap names which operate highly focused businesses, capable of generating attractive returns over the long term.

Though the world has become more uncertain in the past year, high-quality companies tied to long-term secular growth trends should produce compelling shareholder value, regardless of the macroeconomic environment.

Francyne Mu is a Portfolio Manager of the Franklin Global Growth Fund. Franklin Templeton is a sponsor of Firstlinks. This article contains general information only and should not be considered a recommendation to purchase or sell any particular security. It does not consider the circumstances of any individual.

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Three reasons investors should buy in a tech sell off

Tim Davies

Many tech investors have had a tough time figuring out markets so far in 2021. Technology stocks slumped in reaction to rising US 10-year bond yields in April, before rallying sharply through June, with the US NASDAQ market up a very respectable 14% for the half year. While 'mega caps' such as Google, Microsoft and Amazon have proven relatively resilient given the strength of their balance sheet and global dominance, emerging technology leaders such as Afterpay and Tesla sold off more aggressively as investors lock-in profits after strong share price gains in 2020.

The chart below shows the strong rebound in the US tech-heavy NASDAQ 100 index off March 2020 Covid-19 lows. Continued bouts of profit taking following their stellar 2020 performance left the index up just 2% by mid-May. Bargain hunters stepped in resulting in a sharp rebound of 11% over the remaining six weeks of the half year.

With many of the technology stocks falling by 30% or more over the first few months of 2021, many investors are wondering if the sharp rebound is only temporary and a major correction in tech companies will resume before the end of the year.

Source: www.tradingview.com.

But rather than flee tech, we believe these periods of sharp selloffs offer investors windows of opportunity to allocate more of their capital into global technology stocks at more attractive prices.

The world's leading innovators offer investors strong long-term earnings growth over the next decade as their investments into new technology platforms, including blockchain, digital money, cloud storage, artificial intelligence and autonomous transportation, become more widely adopted globally.

There are three key reasons why we believe investing in innovation remains the lowest-risk opportunity to generate excellent long-term investment returns.

1. The Covid-19 dividend drives strong earnings results

One of the main reasons for the 2020 price surge was that many tech companies were beneficiaries of the Covid-19 dividend and the accelerated shift of businesses and people into the digital world.

Technology stocks reported strong results across the board during the Q1 2021 U.S. reporting season. Google (Alphabet) for example, reported a 162% rise in Q1 earnings, while reported earnings per share (EPS) growth surged 162% over the last 12 months.

Alphabet's low Q1 2020 results, depressed from the Covid-19 lockdown, did overinflate comparable growth rates in the last quarter, but Google's results were substantially stronger than market analyst's average EPS growth forecast of 66%. A beat of this size in one of the world's largest companies is rare and indicates that most financial analysts misunderstood the acceleration of exponential growth as we all shifted more of our life online.

A local Australian company that continues to baffle local analysts is Afterpay, which recently reported strong sales growth in the US and UK of 211% and 277% respectively. After a stellar 2020 share price performance, Afterpay saw heavy profit taking over the March to May period, losing almost 50% of its share price. The strong rebound in global technology also resulted in a 60% rally in the last six weeks of the first half for Afterpay. Its share price is now back at December 2020 levels, although announcements of new global competitors coming to Australia create further volatility.

Source: www.tradingview.com.

We believe that Afterpay, which offers younger consumers a payment alternative to traditional credit card options, is still at the start of its adoption curve. Buy-now-pay-later service penetration reached 20% and 38% of the UK and US populations respectively in 2020. We remain confident that Afterpay's offering can deliver robust earnings growth over the long-term as they build market share in retail markets much larger than its Australian base.

Yes, some technology companies were overpriced prior to the most recent tech sell-off, but the strong earnings growth and long-term outlook shown in their latest quarterly results should provide investors with added confidence of share price appreciation ahead.

2. Tech stocks will be the long-term winners

Investors have recently been refocussing on 'old world' value stocks, particularly those heavily impacted by the global shutdown, in the wake of the reopening of the economy and the ongoing vaccine rollouts across the globe. And at the same time, they have sold down some of their Covid-19 winners. Then in the last month, the sharp snap-back in technology stocks coincided with profit taking in over-extended value-type shares.

Many investors believe that over the long-term, 'value' stocks offer a safer investment with technology in a 'bubble' and global inflation fears rising.

But we think the safest way to generate sustainable, long-term returns is to invest in companies that consistently generate long-term earnings growth.

That means identifying companies that operate with long-term structural tailwinds, such as rising cloud adoption, digital payments, and Web 3.0 innovation. We identify the unique value proposition that each company offers to consumers. For example, Coinbase, one of our recent investments, offers a strong value proposition for companies using its digital infrastructure to develop Web 3.0 applications that are regulatory compliant and in an institutional grade custody environment.

By contrast, 'old world' business models face significant headwinds given their generally poor balance sheets, which means they don't have enough funds to invest into the digital infrastructure needed to compete effectively in the digital global economy.

Uncertainty also remains high amongst traditional 'old-world' names, particularly in a rising interest rate environment that would require higher interest payments on big debt levels that would negatively impact earnings.

We believe most sectors can't generate sufficient long-term returns in the face of rising disruption from global innovators. So, what may appear as less risky (investing into the 'old-world') because of lower price volatility is actually riskier over the long-term than a portfolio heavily weighted towards global technology leaders.

3. Valuations look attractive

The third reason that tech stocks are attractive now is valuation. We start by forecasting our most likely estimate for a company's performance out at least 10 years, and then discount the value of each year's free cash flow by 10% from the previous year. Some would argue that a global risk-free rate (US 10yr bond) below 2% could allow us to lower our discount to 7-8% (which would raise our target prices for our investment universe by 50-100%), however we remain anchored to a more conservative 9-10% range.

Following the tech sell off and rebounding during the first half of 2021, we continue to see substantial long-term price appreciation and investment value for investors.

Take Apple for example. It currently trades at 20x 2021 PE multiple (ex-cash), close to the valuation of Australia's leading banks. Apple is extremely well placed as a leading global innovator and will likely maintain over 25% annual sales and profit growth over the next decade. With US$163 billion of net cash, Apple has the immense balance sheet strength needed to fund innovations in blockchain, AI, digital payments, digital health and education.

Source: www.tradingview.com.

As a key beneficiary of our accelerated shift online, Apple shares doubled within six months of the Covid-19 March 2020 lows. Apple's share price has been volatile over the past nine months, and today remains the same price as it was in August 2020. Strong ongoing earnings announcements plus a strong catalyst around their plans to develop a digital bank are likely catalysts for a strong share price breakout in 2021.

As a result of the Financial Services Royal Commission and regulatory measures, Australian banks were forced to raise substantially more capital to protect deposits, lowering returns and restricting their flexibility to engage with innovative customers. They face intense competition from global digital payment systems that usurp the need for banks in B2B and B2C transactions. Long-term earnings prospects look low for Australian banks over the next decade.

A rare opportunity

The recent high volatility in technology shares over the past nine months has left many investors fearing a repeat of the 2001 technology crash but we don't expect significant share price falls for the remainder of the year.

Indeed, now is a great entry level for investors to go overweight in their exposure to innovation. This exposure would include the leading global innovation companies such as Amazon, Google, Tencent and Alibaba, alongside tomorrow's champions in Tesla, Afterpay and Xero. Each offers a substantially better investment return horizon relative to most traditional 'old-world' value investments.

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