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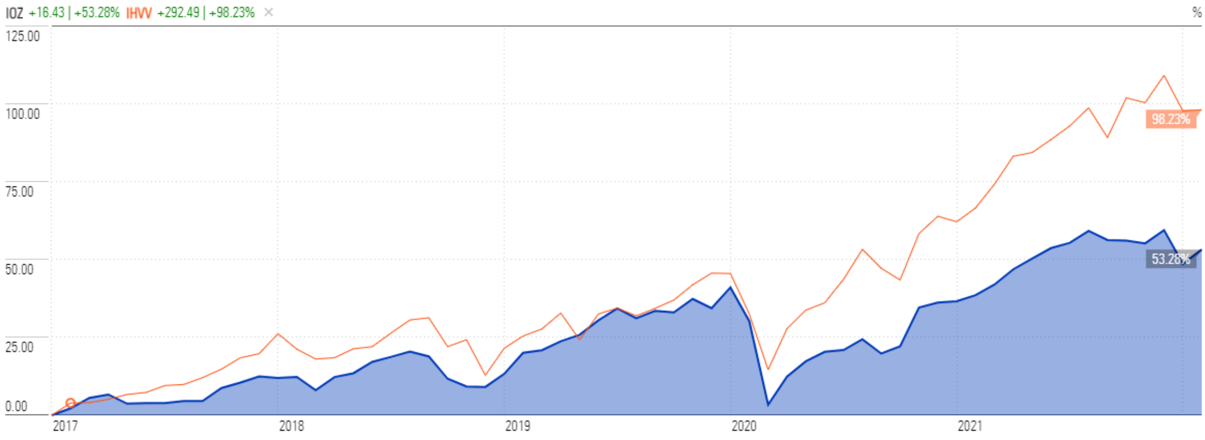
Editorial

In recent years, investors have relied on the 'Fed put', the belief that if the stockmarket falls, the US Federal Reserve will ease monetary policy and rescue the market. It worked in 2018 when the market fell amid a rate tightening cycle, and the Fed reversed its policies. And of course it happened as COVID struck in March 2020, and central banks around the world rode in on white horses.

Why do we in Australia focus so much on the US? Because it dominates global equity markets, comprising about 56% of total global equity market values, versus the next biggest, Japan at 7%, China at 5% and the UK at 4%. Australia squeezes into the Top 10 at about 2% of global market cap. The US is not only the largest foreign investor in Australia, but the place where Australians invest most overseas.

The broad US equity market has performed better than Australia in recent years, mainly due to the success of its tech giants, but the price correlation between the markets is obvious. For example, the chart below shows two index ETFs by the same provider, **iShares**, with the blue representing the S&P/ASX200 (ASX:IOZ) and the red the S&P500 (ASX:IHVV) over the last five years. If the US market falls in 2022, Australia would surely follow, regardless of conditions in the domestic economy.

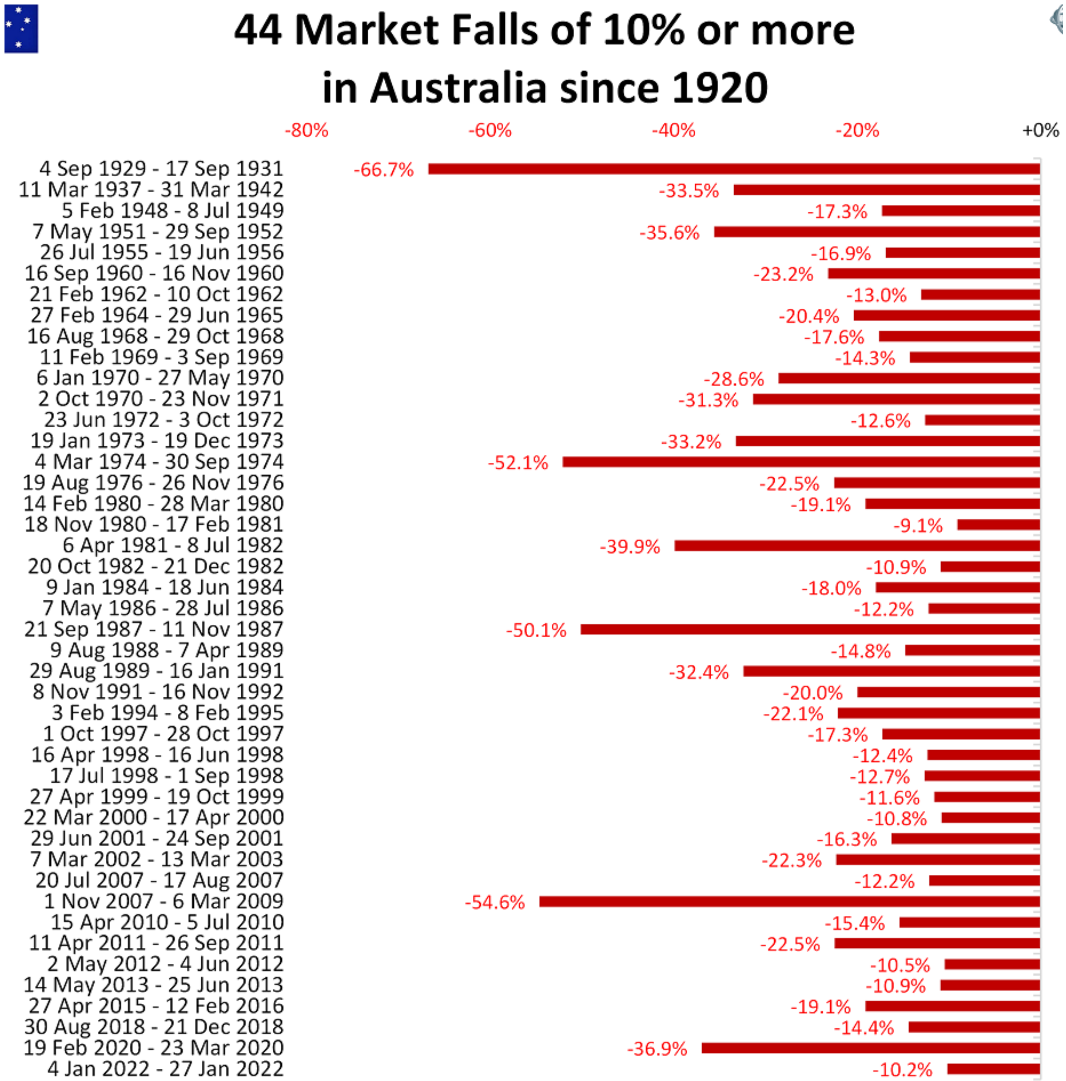


Source: Morningstar

It would be dangerous in the current market to assume the 'Fed put' would save investors in 2022. Inflation was recently reported at 7% annual in the US, giving the Fed a bigger problem that it did not face in prior years. It is now committed to tightening and is already considered by most economists to be 'behind the curve' and acting too slowly.

This is one of the many points made by **Hamish Douglass** in his last interview before taking medical leave as Chairman and CIO of **Magellan**. The discussion focusses on [the way he invests]() rather than the background relating to his personal life and staff changes at Magellan, which have been covered extensively elsewhere. We also discussed wins and losses in his portfolio and how he reacts to market falls.

The chart in my article last week surprised some people, judging by the feedback. It is repeated here because it is a vital lesson for all investors. The data shows the reality of sharemarket investing, which every investor should write at the top of their portfolio or screen, and which I repeat regularly at presentations:



Share prices will fall by at least 10% every two or three years, by 20% a couple of times each decade, and by 30% to 50% every generation. Nobody is immune if they hold stocks, so accept it if you want the long-term rewards from equities.

Along the way, there will be winners and losers, but the best approach is not to bet the house but rely on the slow compounding of wealth in quality companies. In the most recent tech fall out, the criticisms of **Warren Buffett** for his old-world values have reduced as he has caught up with the 2020 and 2021 success of the tech flagship, **ARK Innovation Fund**.

Before we leave Magellan, here are the latest thoughts of **Shaun Ler**, the leading **Morningstar** analyst on the stock:

"Chairman and CIO Hamish Douglass' indefinite leave from narrow-moat Magellan surprised us. But we don't believe this is overly value-destructive for

shareholders. In the interim, Chris Mackay and Nikki Thomas will work with Magellan's investment team to manage its flagship Global Equity strategies. The strategies are in good hands. Mackay is Magellan's co-founder, and was its chairman and CIO until 2012. He is currently managing director and portfolio manager of MFF Capital, a listed investment company of Magellan's, whose investment style is parallel to Magellan Global. A Magellan alumni, Thomas was recently portfolio manager at Alphinity, and her tenure saw the Alphinity Global Equity strategy achieve consistent top-quartile performance.

Despite our conviction in Magellan, our concern is not all investors may be willing to ride out this storm. We lower our fair value estimate to AUD34.50 per share from AUD38, after factoring in 3% more net outflows than before and further trimming our retail fee forecasts. Douglass' leave could add to the list of reasons for consultants and advisors to consider redeeming or haggle lower fees. This follows Brett Cairn's resignation, news of Douglass' family issues, and concerns of underperformance as its holdings Netflix and Meta de-rated in recent weeks. All are immaterial in isolation, but some could view the culmination of them as a sign of firm instability. Long-time client St James's Place's recent redemption is evidence of this."

In our other profile this week, we also interview **Mike Murray** of **Australian Ethical**, who describes why they have launched their first active ETF, a high conviction version of their long-term equity strategy. He also reveals some long-term holdings in companies he especially likes, and a stock he expects to hold for 10 years.

Steve Johnson is a fund manager who looks outside the large companies for the best opportunities, and he thinks small caps are the place where active managers can do best.

Two articles on the impact of inflation of real assets. **Steve Bennett** and **Sasanka Liyanage** check how commercial real estate has performed during periods of inflation, while **Gerald Stack** and **Ofer Karliner** respond to a reader question on the impact of rising prices on infrastructure assets. They also delve into the relative merits of listed versus unlisted assets in this space.

Family trusts are highly popular investment vehicles for Australians, and **Stebin Sam** shows how they give tax and ownership advantages while acknowledging they are not for everyone due to a few disadvantages.

And **Chris Gibson** says the country's future prosperity should not rely on digging up rocks, exporting animals and servicing tourists, but with the right incentives, growth in businesses in technology and health can improve the ongoing chances of success.

This week's White Paper from **Fidelity International** reports on the retirement intentions of Australians, including the emotional journey, why some prefer to continue working and satisfaction in retirement.

The Comment of the Week comes from **Howard Coleman**, on the article on risk tolerance and loss aversion:

"Those who more deeply understand the businesses in which they invest, are pleased with the drop in share prices and use this opportunity to add to their positions. Those who have a shallow understanding of the same businesses, worry that 'the market may know something' and are more likely to panic and sell. So loss aversion is heavily dependent on their depth of knowledge of the businesses in which they're invested."

Last interview with Hamish Douglass before medical leave

Graham Hand

At the Morningstar Investor Conference last Thursday, 3 February 2022, I interviewed Magellan founder, Hamish Douglass. He was relaxed and chatty before the interview, discussing the renovations to his long-time family home, his love of swimming and gym work, and he admired the surrounding developments at Barangaroo. Although one of his larger positions, Facebook (now Meta), had fallen heavily overnight, he projected a fund manager genuinely focussed on the long-term merits of companies rather than short-term price movements. Such sentiment dominated the interview.

During the discussion, I focussed more on what Hamish thought of current opportunities, how he manages Magellan portfolios, how he judged his 15 years of performance, and the coming risks. While some people in the audience no doubt wanted me to ask about his personal life, I felt there was enough revealed and responded to already in the media, and I wanted to discuss investing. He was also unlikely to reveal price sensitive information without a release to the ASX.

Three days after our chat, on Sunday, the "***intense pressure and focus***" on his personal and professional lives seemed to reach a tipping point, and he contacted the Board of Magellan to request "***a period of medical leave to prioritise his health***". The next day, the Board issued a statement to the exchange, including:

"The Magellan Board wholeheartedly supports Hamish taking the time that he requires to focus on his health and looks forward to welcoming Hamish back.

At the request of the Board, Mr Chris Mackay will oversee the portfolio management of Magellan's global equity retail funds and global equity institutional mandates ... Ms. Nikki Thomas has rejoined Magellan as a co-portfolio manager of Magellan's global equity strategies."

Here is an edited transcript of the interview, where he admits to mistakes but also explains why he considers his portfolio is right for the times.

GH: It's my pleasure to welcome Hamish Douglass, the CIO and Chairman of Magellan. Welcome to Morningstar.

HD: Graham, it's great to be with you.

GH: I'm not sure whether you remember this but about 15 years ago, you and Frank Cassarotti came into Colonial First State where I was at the time, pitching a new global fund to be added to FirstChoice. And because we needed a track record, which you obviously didn't have, we initially knocked you back. 15 years and $100 billion later, a lot has happened. At that time, you were talking about delivering to your investors a 9% return through the cycle. The Global Fund has delivered about 12% since inception. So how do you think about or judge that performance?

HD: Graham, it's very interesting because I remember when we first came out with the 9% return, which was right up front. As you recall, this was in July 2007. And actually, markets had been on a roar because it was before the collapse of 2008 and people were kind of yawning at 9% per annum, saying we're not interested in anything under 20% per annum at the time, and we're going, well we just didn't think that was very realistic.

So have we been happy? You know that the strategies, it's since July 2017 and people recall markets last peaked in October 2007. So we're kind of peak to peak. The equity markets peak to peak have done about 8% per annum, measured by the MSCI World Index, and we've done about 12% per annum over that time. It doesn't sound a lot of difference, 4% per annum, but over 14 and a half years, you would have 67% more money invested with Magellan. So the absolute return you earn over time is incredibly important.

And we've managed to do it with materially lower drawdown risk than markets and people get very caught up with this concept of relative or absolute return. We're not thinking about what the share price will do relative to the market at any point in time and frankly, I have no idea what the share price is going to largely do over the next six to 12 months.

GH: Don't worry, I wasn't going to ask you about that.

HD: But what we're trying to do is assess whether or not those earnings on that company over the next three, five to 10 years into the future will compound at a satisfactory rate and then we measure that against the 9% return. That's our focus in investing. We're not speculating, we make judgments around where the earnings of businesses go over time? And if you get that right, you can deliver very attractive absolute returns over time.

GH: When you're thinking about the portfolio, how much do you weigh up this absolute versus relative return because obviously the market and some of your clients think in relative terms and compare you to a benchmark, so you can't totally ignore that. How do you weigh that up?

HD: Yeah, at the end of the day, Graham, I've never found an individual who's retired on relative returns. Historically, the markets have been doing for the last 30 years about 8% per annum. So just investing in the market has been fine because the return in equities has been attractive, but there have been points in history where markets have delivered for 15 years, zero rates of return.

If we did let's say 2% better than the markets over a period of 15 years and the markets did zero, we would be very unhappy. And a lot of people would say that's a great result. If we don't do 9% per annum even if the markets do zero over an extended period of time, we don't think we've done our job because people don't retire at 2% per annum even if it's beaten the markets.

I would look out from here and caution people because interest rates have been falling and they've been exaggerating equity returns for 30 years. I think equity returns from markets are going to be lower than they've been in the past. Our job is to make judgment in a select collection of businesses that we think can compound people's capital to get us that 9% return per annum. If you can give people 9% per annum over the long term, that means every eight years we're doubling our clients' money. People can effectively withdraw 4% per annum and therefore have their capital still growing in real terms that they can give to the grandchildren.

But if you deliver 2% per annum and the market is zero, you're going backwards, you better lower your lifestyle expectations, you better lower what you want to leave with your children. Over the long term, our 9% per annum I actually think will beat any equity long-term benchmark measured over a long enough period of time. But in the short term, the share prices of businesses can go anywhere.

I don't really pay any reference to what Microsoft share price will do relative to an index of 1600 companies in the next six months but I have very, very high conviction over the next three, five and 10 years Microsoft will deliver a very good return for our investors but do I get caught up if Microsoft underperforms the market in the next six months? I don't even think about it.

GH: We know the market falls by 10% every few years. When that happens with your portfolio, what's your emotional reaction? Do you say, great, this is a buying opportunity or do you think, my clients have just lost $10 billion? How do you manage those big changes?

HD: If the markets drop 10%, of course, there is a mark to market apparent loss. But you only lose if you actually sell anything at that period of time. Do I worry about that? Normally I'll look at it as an opportunity. As an investor, people need to understand when they're invested in equity, the market gets quite emotional. And in the short term, it's this sort of emotional voting machine.

Two weeks ago, Netflix's share price fell 20% after its result. It's recovered its losses over a week. So you know what's happened in the last week of a rollercoaster? If you went away for a week, nothing happened. But during that week it looked like this incredible emotional experience. People need to understand that equities in the short term can be very, very volatile.

It's interesting that people's major asset is their house. Do people ask a real estate agent to value their house every single day? Depending on the mood of that real estate agent, they can tell them it's gone up 5% today and the next day they're told it's gone down 5% and then people are getting worried that their wealth is falling because their house price is going up and down.

The market's an odd thing that is throwing you a price every single day but if you think about it, what you own hasn't changed at all. You still have the same interest in those businesses with the same prospects of those future profits. But day to day they jump around in price and what I'd say to people is you're better switching it off. Equities is a long-term investment game. And if you get the right collection of businesses and they compound their earnings, in the end the market's a weighing machine as Ben Graham says and the returns will look after themselves.

So when the share markets go down 5%, do I think we've lost anyone any money? No, I don't, because we still own exactly the same assets which have the same prospects the day before they fell and the day after they fell.

GH: Hamish, you're clearly a stock picker, an active stock picker, but you do make macro calls as well. You change your cash weighting accordingly. And when you speak, you obviously talk about inflation and viruses and macro things. How do you weigh up that stock picking versus the macro call because going to cash means you're out of the market to a certain extent.

HD: Well, let's put it in context. We can go up to 20% cash, so I'm always 80% invested in equities. I think we have to put any decision we make around macroeconomics in context. So we're normally above 90% invested in equities and often above 95%.

Why do we use cash and macroeconomics? It's really risk management. We're very conservative people and if we see risk out there that we think isn't priced in markets, we may for a period step back a little bit. We're taking less risk in order to preserve more capital and to give us a little bit more breathing space and firepower to take advantage if there is a sell off.

I think we've had a pretty successful record, not always but I think our batting average has been strong in making the judgment call of when to put risk on and risk off in the markets but you don't get everything 100% right. But I don't think people should worry about it that much. Because we're always going to be 80% invested in equities while we take a conservative view of looking after people's capital.

GH: As an investor, I would rather you didn't do that because if I allocate some of my portfolio to Magellan, I'm saying that's my equity allocation. That's 100% in equities, and I'll look after the risk management in the rest of my portfolio. I don't want to have to say that actually 20% of that portfolio is in cash. Obviously, you see a different position.

HD: Yeah, we do see a slightly different position at the end of the day, I think we've put an absolute return target on that. And we know if we sit in cash for an extended period of time returning nothing, that's going to make our job of getting 9% per annum harder. We absolutely understand that cash is not going to compound at 9% per annum, we're only doing it as part of our portfolio construction and risk management. We're not guaranteeing by the way the 9% but we have it as the absolute benchmark.

GH: It's tempting at any point in time to look at all the pluses and minuses in the market and heaven knows, we've got a lot of them at the moment, but is it trite to say investing at the moment is more difficult than ever, or is it always difficult?

HD: I don't think it's always difficult because when you find a great business and you want to stick with the business for a long time, it's not that difficult. But sometimes finding them is difficult but once you've got them, sticking with them isn't that difficult.

People need to understand that this environment is potentially different this time, and normally we should never say it's different this time. The valuation of equities relative to economic output is the highest it's been in 100 years. And it has jumped very materially with the stimulus in the last 18 months. Not relative to current earnings because earnings are elevated the moment, but compared to the total output of economies, we are off the charts in equity market valuations and normally that will put a little question mark in your head.

But we're also at the end of the stimulus cycle, and we're about to go into a stimulus tightening and then we've got this threat of inflation out there. And for the last 15 years, every time there's been a correction, the central banks have rescued the market by printing more money. If we have inflation this time around and interest rates at zero, that game's up. I do think the situation is different and that the game book is different. If we get into trouble, it could be much uglier this time because there are fewer things the central banks can do in an inflationary environment to rescue the situation.

GH: You just said that, if we have those factors, this time the 'game is up'. What are you actually looking for in a signal prior to the market going down 30%, that tells you the 'game is up'?

HD: Well the markets being off 30% would be a good result in the 'game's up' scenario, I'd probably put the market off 50% and I'm being serious about that.

In the 'game's up' scenario, where inflation is persistent and the US Fed Reserve later this year has to start tightening monetary policy materially faster than just a sort of a normalisation. I really think we could be in a world of pain if that was to happen. I think there are two things you need to look at to make a judgment call on the inflation 'game's up' scenario. There are very strong arguments about these inflation pressures. The US has just printed 7% inflation, it's staggering having inflation at that level, and Australia is of course going up, but the US is what sets equity markets and we have to watch the United States.

We would expect when economies reopen from omicron we should get a change in demand for goods. A lot of people were at home buying goods, they were buying more televisions and stuff for the next barbecue and gym mats ... we were over-consuming goods at the same time as supply chains were constrained. So you'd expect as we normalise human activity, we'll start switching out of goods and into services, going to restaurants and holidays and that should take pressure off supply chains.

A lot of this wages inflation is because Australia doesn't have 300,000 students here. How many of them work in restaurants? And tourists who come here, many are under 35 and they work at the farms and other places. None of them are here and this is before you even get to the migration debate. So reopening borders should actually get a deflationary force coming through the economy.

So I don't want to paint it's all inflation. I think this is quite evenly balanced at the moment. But we are starting to see in the United States material movements in consumer expectations. You have to think about the US consumer and what they are experiencing, not what economists are publishing. We've got elevated energy prices that the economists strip out, but look at utility bills, up 15 to 35%. Even the standard shopping basket, we have things like eggs and bread going up 30%. All the companies we speak to are starting to put through material price increases, such as McDonald's last year put up prices by 6%. Expectations change and the wages cycle starts moving, that is when the central banks are in the corner. So if we don't get this rollover effect (from goods to services) before people's expectations of prices change, I think we've got a problem in the US.

The other one is China because they are the world's supply chain. And unless China relaxes its zero COVID policy, we are going to have continuous stop starts in the supply chain and that could extend the persistence of supply chain constraints and make the inflation risk more.

I'm not saying the game's up. I'm saying there is a material risk it could be up. I think we're in a world of pain because of monetary policy being tightened, we're ex-stimulus, but if we really have to move monetary policy in the United States, it's kind of 'hold-on-to-your-chairs'. I don't know how these balls will drop.

GH: It's a fascinating time. We have a family business and every week a new letter comes in from suppliers about the rising cost of jars, freight, ingredients. And expectations get embedded into the system.

HD: When people start feeling it everywhere and then they say, well my wages are going up 3% and prices going up 7%, I'm going backwards here.

GH: You recently described your portfolio as having strong defensive characteristics but we see a lot of the leading tech tech stocks, Alphabet, Microsoft, Netflix. What's your argument that it's a defensive portfolio?

HD: We actually have two portfolios in the strategy. So 50% of our portfolio is in businesses like Nestle, PepsiCo, Procter and Gamble - which owns probably the biggest collection of consumer brands on the planet. We own utilities, we own some infrastructure stocks and we have a bit of cash. So half our portfolio, which is much greater than the market, is in very defensive businesses. But you're right on the other side of the portfolio, we've then got some more growth assets. Some of those are defensive but some of them are less defensive but they're incredibly long-term compounding stories.

If you just have a look at what the results from Alphabet were this week, which owns Google, the revenues were up 32%. If you look at Microsoft, their revenues were up over 20% in the last period, absolutely incredible. We've got businesses that are transitioning their business models, in a technology sense, like SAP. That transition is going to have nothing to do with inflation or any of these debates. Their business is about how they transition their 40,000 customers from a business model of on-premise to the cloud. That's their story. It's idiosyncratic to a lot of the issues you're talking about.

We have Visa and MasterCard, they're a royalty on spending around the world. But if we get inflation, they're a royalty on inflation as well, but sure there is economic sensitivity in part of our book. We effectively run about 80% of the risk of markets in terms of the overall exposure to volatility. You have to look at how the whole thing works together.

GH: You recently said, *"Why would I invest in turnaround stories when there are so many great companies"* and that's actually the reverse of what a lot of fund managers say where they look for beaten up companies, the ones which have problems, where share prices are marked down by the market. They buy the turnaround, but you don't accept that proposal.

HD: It's a difficult way to make money. Buffett has a famous saying that turnarounds seldom turn. Normally, when you're buying into turnarounds, the businesses are going backwards, have been overearning and they're having to reset themselves. And in all of that reset, they're incredibly time dependent. And I would say time is the enemy of a turnaround, because often your rate of return is depending on how quick that turnaround can happen. Because they're businesses that are struggling, they don't compound over time. You're looking for an earnings reset story, margin reset story and then a re-rating by the market.

If you invest in wonderful businesses, that compounding and time are your friends. The longer the time goes on, the more money you're going to make because it's a simple law of compound interest. So we want to be in compounding stories. I wouldn't say we never invest in a turnaround, but it's much more difficult. We believe in the magic of compound interest and turnarounds aren't compounding machines.

As Benjamin Franklin said, money makes money and the money that money makes, makes more money. And that is what investing is all about. It's putting away some money today and letting that money work for you over time. So it is just how we're philosophically wired.

GH: Before we turn to audience questions, last one from me: What question should I have asked you?

HD: Well, the question you shouldn't have asked me is what keeps you awake at night? Because that's a question that most people ask.

I think a great question when you're an investor, is if you had to own one company for the next 10 years, what would you own? How would you go through an assessment in making that decision? You'd first start to ask, what are the competitive advantages of the business? What are the threats to the business? What are the threats of disruption? What do you think their revenues will grow at for the next year? How confident are you? What do you think the competition looks like in that industry? Because you're only making one shot, you don't want to lose your money. You don't start thinking about the stock market and the relative returns. You think about the business. And that's how we think.

And if people ask themselves that type of question, they would think very differently about how confident they are. People get caught up with market movements and everyone piles in at exactly the wrong time.

If I could nominate one company, it'd probably be our largest investment, Microsoft. I think their cloud-related businesses and the diversification have so many advantages and where they're priced at the moment. Over the next 10 years, I would be very confident of putting 100% of my money into Microsoft, and never getting an opportunity to see what its share price is for another decade.

I'd be confident about putting my money in Nestle although I probably wouldn't get as high rate of return. I'd be very confident in PepsiCo, I'd be very confident about Intercontinental Exchange. There are some businesses that I'm probably not be as confident about in the next decade, such as Visa or MasterCard, fabulous businesses but there is some disruption out there.

As an investor, you're not thinking about the market, you're thinking about the business and what type of businesses you want to have your money invested into.

GH: Let's turn to some audience questions. How do you suggest managing equities in a rising rate environment?

HD: Yeah, a rising rate environment is difficult, particularly if rates go up meaningfully. If rates going up 0.5%, it isn't going to make much of a difference but if rates go up 2 or 3% is a very significant headwind. Warren Buffett describes interest rates as the gravity of markets. Asset prices are the discounted value of future cash flows and if you increase the discount rate, the value of those future cash flows go down. That's why interest rates are a headwind.

How do we manage that? We want to have businesses that inherently have pricing power and we want them to have low capital intensity, that hopefully they can be growing their earnings in line with inflation.

The other thing is the multiple of earnings changes. So something that may have traded at 22 times earnings may trade at 20 times with higher interest rates. That change has a short-term impact but it doesn't compound over time. You want the ability to compound real earnings (earnings adjusted for inflation) over time. If interest rates jump up, markets are going down, we're going to get affected and everybody's going to get affected. So as an equity investor, if we get a big jump in interest rates, I can't promise anyone we're going to go up, that is completely unrealistic. I think our portfolio is much higher quality and has much better attributes to deal with that world.

GH: Do you feel you relied too much on the China story, particularly given some of the controls that the Chinese government has imposed on certain businesses in the last year or so?

HD: It's a very good question. I made a mistake on China. I got overconfident in China because I really liked the businesses in Alibaba and Tencent. They're wonderful businesses but I underestimated the Communist Party risk. And it's really a regulatory risk, which happened after the IPO crack down. We bear certain regulatory risks. We bear it in the payment sector, where we bought Western technology companies, we bear it in stock exchanges when we invest in them, and in clearing houses.

So we understand regulatory risk but the biggest mistake on China was owning two technology companies, and they both got caught up in a regulatory crackdown. We now have less than 4% of our portfolio in China. We don't think China is uninvestable, but you really have to think about that sort of risk in China and manage that in your portfolio.

I'll accept completely I made a mistake, but you know, you make a few mistakes in your investing career, it's what you do about it. We've taken action. That China regulatory risk is never going to be material in our portfolio again.

GH: Are you concerned that your US-specific exposure is too high given the particularly high valuations in the US market and are you looking at opportunities in other countries?

HD: This is always a bit of a misnomer. We have 70% of our portfolio in the United States and nearly 60% of the (global) MSCI is US companies. So we're not that much different to the overall market. But when we look around the world and we look at the valuations, the US market as a multiple is higher than other markets, but the United States has many more tech companies than other markets.

When we go around the world, we don't suddenly say, look, consumer staples are much more expensive in America and cheaper in Europe. It's just not factual. We don't find banks more expensive in America compared to banks in Australia or Canada or the UK. So I think you have to be very mindful that aggregate market multiples do not tell you what individual companies are worth.

And whilst we look like we're overweight United States, we are overweight global multinationals. Coke has only 20% of its earnings in America. You might think I'm making a bet on America if I'm invested in Coke, but 80% of their earnings are outside of America. Nestle which is a Swiss company but only 2% of their earnings come out of Switzerland and 34% of their earnings come out of America. So Nestle is much more American than Coca Cola is.

Many of the world's great technology-related multinationals came out of Silicon Valley and Seattle. We invest in the companies, not where they're necessarily listed, per se. We've got very few what I'd call domestic US plays, so we're not taking a particular play on the US itself.

Hamish Douglass was Chairman and Chief Investment Officer at Magellan when he was interviewed at the Morningstar Investor Conference on 4 February 2022. [Magellan Asset Management] is a sponsor of Firstlinks. This article is for general information purposes only and is not investment advice.

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Mike Murray on watching for the changing narrative

Graham Hand

Mike Murray is Head of Domestic Equities at Australian Ethical, which manages over $6 billion in Australian equities and multi-asset funds. Australian Ethical has launched its first ETF, the High Conviction Fund (ticker: AEAE).

GH: After a long history of funds in the unlisted space, what has motivated the launch of an active ETF and why this particular fund?

MM: There's been a huge growth in demand for ethical investments and people want something that's true to label and ultimately it needs to be accessible. That's where the ETF comes in. It's a good product in terms of the ease of use and not having to fill out all the paperwork that typically goes with a managed fund. And while there have been a lot of fund launches in the sustainability space, there aren't a lot of true domestic ethical active managers in the ETF space. So we thought there was a bit of a gap there.

GH: You've chosen the High Conviction version, what was behind that?

MM: High Conviction means a more concentrated strategy than some of our other strategies. It aligns with our ethical charter and active management, looking for sustainable business models but it also plays a bit higher up the market capitalisation curve. It holds some small caps but it is a bit more overweight some of the mid caps and larger cap stocks, and that gives it a bit more dividend yield. It's not really reinventing the wheel. It's an extension of what we're already doing.

GH: What will be the maximum weighting allowed in any one stock?

MM: Up to 10% in an individual name but that's unlikely in practice, we'd expect 5% to 7% would be a typical position for a larger capitalisation stock.

GH: ESG and sustainable investing is pretty much mainstream now, you hardly find a fund manager who doesn't claim to operate under these principles. How does Australian Ethical maintain a point of difference?

MM: It's a good thing that it's mainstream, but we've got an ethical charter that's really unchanged for 30 years, and we only do one thing. Probably a slightly more nuanced point is that we don't think ethical investing is exactly the same as ESG. Ethical investment goes deeper, it's more about values, aligning the portfolio with the values of the client. We think some things have inherent value, creating a positive impact on people, the planet and animals. Those things have inherent value that we can't necessarily measure in risk and return.

GH: You've been at Australian Ethical since 2016. What's been your best investment decision over that time?

MM: A company that's done very well in the last five years is Fisher & Paykel Healthcare, a very innovative company and that's one of the keys to their success. They had a core technology relating to humidification of ventilated air in hospitals and so they benefited from making a positive impact in the COVID setting. They moved into CPAP and the nasal high flow, which is a type of oxygen therapy. The share price over five or six years has gone from $10 to $30. We're not actively adding to the position but we like the management, its organic growth profile and the business model.

GH: And on the other side of the ledger, is there a stock that you sold recently that's made you think about your investment process and how you analyse investments?

MM: Well, not a company that we've sold recently but it's under takeover. One that hasn't gone according to plan is Australian Pharmaceutical Industries, API, the pharmaceutical wholesaler and they also own the Priceline franchise business. We believed in the Priceline footprint and the company met our ethical hurdles as well. But shortly after investing in the company, the management changed and became more focused on acquisitions rather than organic growth, some outside their core competency. It hasn't really delivered in terms of earnings. The lesson is to watch for changing narratives in companies when you're meeting with them. When a company starts acquiring outside its core, sometimes it tells you something about their core business and the growth profile.

A slightly more nuanced thing is that we have done much better at product-oriented companies than service-oriented companies. A case in point is aged care, which was a hot sector for a while but it hasn't really delivered, it hasn't scaled, and we think product-oriented businesses scale better than personal services.

GH: Do you own a stock that you expect to keep for a long time, maybe 10 years?

MM: We are very patient providers of capital but when you're a fund manager, a lot of things change in 10 years, you might even see two or three CEOs. You can see companies get very overvalued or very undervalued in that period and if a company becomes very overvalued, we would sell it. Cochlear is another company we've held for a long time, it's a market leader and the business does tremendous social good and their markets are under penetrated. They've got a high gross margin. They probably raised too much capital during COVID which was very conservative as business bounced back much quicker than people expected. They've ended up with $500 million of cash on the balance sheets, they're conservatively geared. So you pay a high PE but over a 10-year period that will come down, given the strong growth rate.

GH: And a good business to own for the previous 10 years as well. Can I delve into your ethical process a bit more? When you're assessing a stock like Coles or Woolworths, which both sell tobacco, alcohol, sugary products, which are on the negative side of the ethical ledger. How would you weigh up owning a stock like that?

MM: That's a really good question. We distinguish between companies that are direct producers of some of those harmful products … and we do think they're harmful, there's no real debate about that. In this case, they are retailers, we would not classify them as direct producers, they are indirect participants in those markets. The second part is: are they selling more than their natural share of those products and are they strategically involved in those industries? We don't think those companies have an overweighting in those areas.

And then we ask if there are other positives in the business, and we think the answer is yes. Both those businesses are important in the overall economy. Coles is held in the High Conviction strategy and is committed to 100% renewables by 2025. They are signatories to the alcohol beverage advertising code, we can see quite a lot of positives. None of these companies is perfect so we're always making these judgements.

GH: Do you own any stocks now which may not have passed your ethical screens, say five years ago?

MM: We've seen both sides. We no longer invest in Tasmanian salmon producers for ethical reasons. But on the other hand, a company like Downer moved out of the mining contracting space into more of a light footprint, urban contracting business with a big role to play in energy transition. In building, there is a commitment from some businesses to a lower footprint and newer technologies, such as Fletcher Building and Boral. And in other cases, the end use of a product has changed, such as with lithium. Traditionally, we would not invest in mining companies but they are important for batteries and decarbonisation.

GH: Finally, any new developments at Australian Ethical coming this year?

MM: There's enough going on in the field of ethical investment to keep us occupied. You should expect us to stick to our knitting. We don't have a big presence in active international equities at the moment. That's something with some very interesting technology addressing society's problems. And more ETFs as we look across our product suite, they are on the radar.

Graham Hand is Managing Editor of Firstlinks. Michael Murray is Head of Domestic Equities at Australian Ethical, a sponsor of Firstlinks. This information is of a general nature and is not intended to provide you with financial advice or take into account your personal objectives, financial situation or needs.

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What are the advantages and disadvantages of family trusts?

Stebin Sam

Most people tend to follow a pattern in life. They go to school, obtain qualifications, get a job, pay taxes, and eventually settle down with a family. During this time, many make investments and even start a business to increase their wealth and assets.

They can either own those wealth and assets in their own name or set an alternative structure like a family trust to hold them. Such a structure could assist with tax planning, asset protection and obtaining tax benefits.

This article discusses the advantages and disadvantages of family trusts.

What are family trusts?

A family trust is a discretionary trust that is used in Australia to hold the wealth and assets of a family. It is also commonly used as the structure for family businesses.

A trust is a legal structure under which a person (the trustee) holds the legal title of a property for the benefit of other people (the beneficiaries). The trustee has a wide range of powers to deal with the property, and any profits generated from that property are distributed to the beneficiaries.

A discretionary trust is a type of trust structure. The most distinguishing feature is that the trustee has the discretion on how much to distribute to each beneficiary if any money is distributed. The beneficiaries are not guaranteed to be paid, they just have an expectation of being paid.

In family trusts, the beneficiaries are usually members of the same family, and a person from the family or a company controlled by the family will be the trustee. This trustee has broad discretion including on the distribution of the income from the trust.

Let us look at some of the advantages and disadvantages of a family trust.

Advantages	Disadvantages
Tax planning	Ability to grow if used to run a business
Asset protection	Family disputes
50% capital gains tax discount	Liability of the trustee
Carry forward losses	

Advantages of family trusts

1. Tax planning

A family trust is taxed at the highest income tax rate, which is 45%. However, any trust income distributed to the beneficiaries is taxed at the income tax rate of the beneficiary who receives the distribution.

A family trust is commonly used to minimise the total income tax paid by the whole family. Generally, the trustee in a family trust distributes the trust income among the trust's beneficiaries and allocates more distribution for a family member with a lower income tax rate than the other parties. This reduces the total amount of tax paid on the trust income by the beneficiaries.

2. Asset protection

A family trust structure can protect your family's wealth from creditors. Usually, when a person owes money and cannot meet the repayment requirements, the creditor can access the person's personal asset to recoup the debt payable. Personal assets include your home, car, and other property a person owns in their name. If the family trust is holding the personal assets, then the trust's beneficiary has no legal rights over those personal properties and creditors of the beneficiaries cannot access them. This includes even if a beneficiary becomes bankrupt.

3. 50% capital gains tax discount

A capital gains tax is payable on any profits from the sale of an asset. A family trust receives a 50% discount on capital gains tax for profits made from selling any assets the trust has held for more than 12 months.

4. Carry forward losses

A trust does not distribute losses to beneficiaries. This means the beneficiaries will not be called upon to contribute money to the trust to meet any loss. Instead, losses from each year can be carried forward to the following year.

Disadvantages of family trusts

1. Grow as a business

A family trust is also used as the business structure for family businesses. While this structure offers benefits like those outlined above, it restrains a business's ability to grow. Due to the high tax applied to trust income that is not distributed, trustees almost always distribute the income. Therefore, the business cannot retain the profits to reinvest in the business for the following years. Lenders such as banks are reluctant to lend to trust structures when compared to other business structures like a company.

2. Family disputes

It is usual for families to have disputes. Disputes about the control of the trust can occur where the trust holds a significant amount of family wealth. If the trust deed does not clearly set out the procedure to appoint or replace a trustee and how trust income should be distributed, then family disputes are more likely to occur. To avoid such disputes, the trust deed must set out clear procedures.

3. Liability of the trustee

A family trust provides excellent protection for beneficiaries both from an asset protection and tax planning perspective. However, a trustee is legally liable for the obligations of the trust, including any debts it owes. This can cause significant personal risk to the trustee if the trustee is an individual, which is why a company is often used as the trustee.

Should you set a family trust?

The merit of a family trust depends on your personal circumstances. You will need to get independent legal and financial advice to determine if a family trust structure could benefit you and your family. Note that transferring existing assets to a family trust will come with tax implications.

Stebin Sam is a practising commercial solicitor at LegalVision and a freelance content writer. LegalVision can be contacted on 1300 544 755 or their membership page. If you need help with setting up a family trust, LegalVision's experienced corporate lawyers can assist as part of its membership offering.

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Infrastructure assets are well placed for inflation era

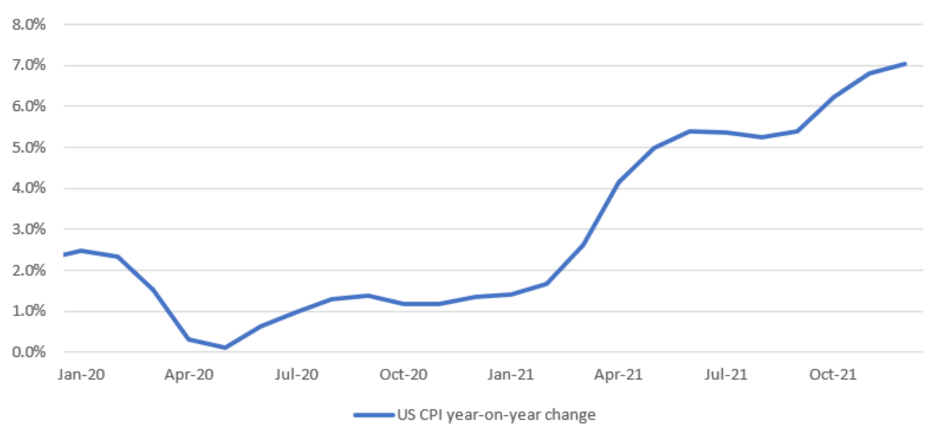
Gerald Stack, Ofer Karliner

We received this request from one of our readers:

"Hi Guys.
Enjoy reading your publication.
I have an interest in investing in infrastructure (5 in's in a row ... must be a record!!). Could you think about providing an article on infrastructure investing in listed and unlisted funds, and also examine the effects of rising interest rates on these funds. Thanks."

Global share prices dived in January as US stocks suffered their worst month since the pandemic began in March 2020. US shares sagged mainly because the Federal Reserve warned it would raise rates to counter US inflation, which reached a 40-year high of 7% in 2021. For the month, the S&P 500 Index shed 5.3% in US dollars (and 2.3% in Australian currency), its worst January since the GFC.

US Consumer Price Index (CPI) - January 2020 to December 2021



Source: Refinitiv

Inflation protection in infrastructure

As inflation accelerates worldwide, many investors are turning to stocks that are renowned for their inflation protection, especially infrastructure and utility stocks.

The discussion here assumes companies defined as infrastructure companies meet two criteria.

First, the company must own or operate assets that behave like monopolies.

Second, the services provided by the company must be essential for a community to function efficiently. Such companies have predictable cash flows that make them attractive defensive assets.

The key inflation protection for utilities stems from the fact they are regulated at the point of earnings. Their regulators set the price of the service supplied by the utility such that utilities earn a 'fair' return. When inflation boosts input and other costs, including the cost of capital, regulators allow utilities to raise their prices to ensure their returns compensate shareholders fairly over time for the capital invested to provide their services. If the regulatory process is working efficiently, then accelerations or decelerations in inflation and related changes in interest rates should have limited influence on the financial returns of regulated utilities.

The same goes for most infrastructure assets. The prices charged for services by infrastructure assets such as toll roads or airports are typically linked to inflation through either regulation or contract. The value of the business is thus somewhat protected from changes in inflation. Inflation can even boost the value of infrastructure assets over time because these assets typically enjoy higher patronage as populations and wealth grow.

Listed and unlisted infrastructure assets are inflation-proof to the same extent because the structure through which the assets are owned doesn't change the economics of the assets. The economic model for the assets will reflect demand for the service the asset provides, the regulatory framework the asset faces and the underlying cost structure for the service provided.

Listed versus unlisted

Investors who can see the inflation-protection benefits of holding global infrastructure and utility assets face an early decision: choosing between listed and unlisted infrastructure assets. Many might tilt towards listed because it comes with some key benefits compared with unlisted.

1. An ability to invest quickly

While it can take investors many years to find available assets and invest their capital in unlisted infrastructure, hundreds of millions of dollars can be invested in a matter of days in the world's best listed infrastructure companies.

2. Easy diversification

The global listed infrastructure and utility universe followed by Magellan contains more than 130 companies from 22 countries and 10 industry segment classifications (as defined by Magellan). This choice means that investors can build a well-diversified portfolio of listed infrastructure stocks on a regional and industry basis.

By comparison, it is not uncommon for unlisted infrastructure funds to hold a concentrated portfolio of 10 to 15 assets that is typically biased to a sector or region. Ultimately, portfolio composition for unlisted funds is heavily dependent on what assets are available at the time the fund is being invested.

3. Greater transparency

Listed securities are transparent, in contrast with private infrastructure funds that can often demand a 'blind commitment' to what may be a portfolio of low-quality assets.

4. No costly failed bids and related costs

Unlisted infrastructure funds generally start with a sum of money and then they bid to buy assets. These bids often fail and come with costs. Each bid can involve significant outlays for legal, tax, accounting and advisory services, which are ultimately borne by the investors whether the bid succeeds or fails. Even the most experienced infrastructure managers are not successful with every bid.

5. No forced sales

Listed infrastructure assets face no forced asset sales. The bulk of private infrastructure and unlisted funds are 'close ended' with fixed periods until termination. At the end of the term, assets need to be redeemed (unless there is a vote to extend the term) and this could result in the sale of assets in sub-optimal market conditions. The open-ended nature of listed assets means exposure can be held indefinitely.

6. An ability to tilt across regions and sectors

Once investors have built a well-diversified portfolio of global listed infrastructure stocks, they can readily adjust holdings across sectors and regions to take advantage of different market conditions. This ability can enhance the risk-return profiles of listed infrastructure portfolios. Unlisted infrastructure funds are restricted in their ability to make medium-term tilts across regions and sectors during the life of the fund by the illiquid nature of the unlisted infrastructure investment universe.

7. More liquidity and live pricing

The listed market is liquid enough for investors to easily gain and reduce exposures to global infrastructure companies. The live pricing allows the immediate valuation of portfolios, unlike the unlisted market where valuations are infrequent and opaque.

The management of illiquid assets within an overall asset allocation framework can make it hard to maintain proportionate weightings. Acquiring private market assets takes time and a significant public market rally or downturn can upset the balance in a portfolio and potentially exacerbate the cyclical nature of portfolio returns.

8. More mispricing opportunities

Analysis suggests that over the past decade, listed infrastructure investment opportunities have traded at a material discount to similar infrastructure assets in the unlisted market.

In theory, private market infrastructure assets should be priced at discounts to their publicly traded equivalents due to their illiquidity. This discount should present an opportunity for investors with typically longer investment horizons to trade off liquidity for superior long-term returns.

The opposite, however, has been the case in recent years.

Demand-and-supply dynamics for private market infrastructure have shifted such that many of these assets have consistently been acquired at valuation premiums to their publicly traded alternatives. Part of this reflects the intense competition for many assets in unlisted markets, driven by the sheer weight of capital in the sector. Data provider Prequin estimates that the total capital waiting to be deployed in unlisted infrastructure funds is US$300 billion, up nearly 300% on a decade ago, and that doesn't include major institutional investors, such as pension funds and sovereign wealth funds, who also invest in these assets.

Gerald Stack is Head of Investments, Head of Infrastructure and a Portfolio Manager, and Ofer Karliner is a Portfolio Manager at Magellan Asset Management, a sponsor of Firstlinks. This article is general information and does not consider the circumstances of any investor.

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The relationship between inflation and commercial property

Sasanka Liyanage, Steve Bennett

The big picture

The Reserve Bank of Australia's (RBA) most recent Statement on Monetary Policy reiterated that although inflation has picked up, price pressures in Australia remain considerably lower than in other countries. The near-term inflation trajectory was marginally upgraded, however, it is expected to remain within the RBA's target band across the forecast horizon. The RBA expects core inflation to continue to drift higher and reach 2.5% over 2023. It also reinforced its stance "*not to increase the cash rate until actual inflation is sustainably within the 2-3% target range*". The RBA has highlighted that the trajectory of inflation will be important, "*with a slow drift up in underlying inflation having different policy implications to a sharp rise*". Over recent weeks, longer-term rates have increased back to pre-pandemic levels in anticipation of major central banks looking to raise rates.

At Charter Hall, we don't pretend to know what the future holds in this space but, on balance, we subscribe with the views of the RBA that pricing pressures that have emerged across the market have largely been transitory and appear to be stabilising.

In this article, we examine the relationship between inflation and commercial real estate.

Inflation and commercial property

There are several inflation protections built into commercial property leases, particularly long-term leases. These generally include annual fixed increases, often at a given rate above the Consumer Price Index (CPI) rate. For example, a long-term lease in an industrial property might have annual rental payment increases structured at a fixed percentage plus CPI (e.g., annual rental payment increases of 3.0% would equate to a 0.5% fixed percentage plus 2.5% being the 12-month CPI rate).

Even when not linked to inflation, typical annual rent increases are set above the long-term outlook for inflation. For example, the average fixed annual rent increase across our two unlisted direct office funds average around 3.5%. Importantly, long-term leases that are either directly linked to inflation or set above long-term inflation averages can provide protection as they extend beyond short-term volatilities in inflation.

Leases may also contain expense pass-through mechanisms. With many of our lease arrangements, particularly triple-net leases, most of the expenses and capital works are 'passed through' which means the tenant is responsible for these expenses and capital works – not the landlord, providing protection for commercial property owners from any rising expenses.

A further protection for commercial property relates to supply, with higher construction costs slowing new developments.

Other factors that influence inflation and commercial real estate

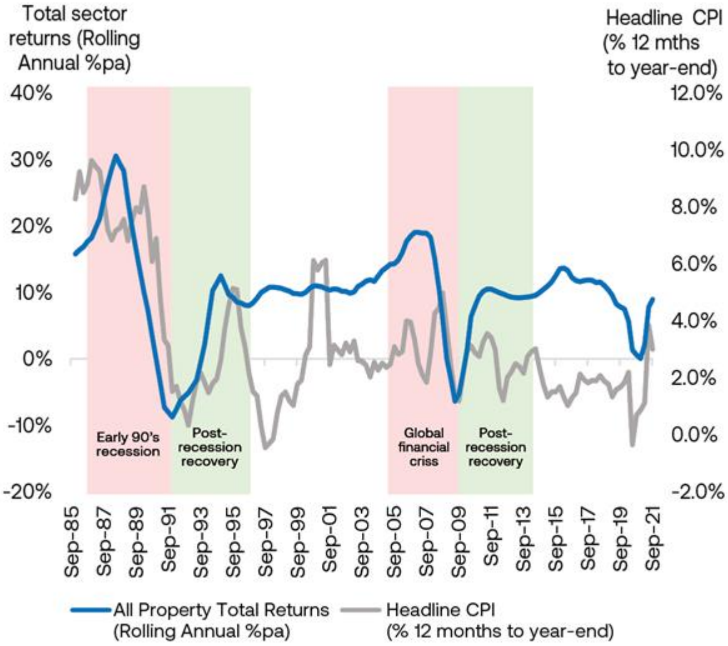
Real estate occupier demand: Physical market drivers and real estate demand have a large impact on real estate asset performance. Elevated market vacancies can moderate rental growth, reducing the power of the inflation link for leases. However, higher quality assets typically have lower levels of vacancy, longer lease expiry profiles and stronger pricing power. These assets provide greater income stability and more robust investor demand, providing strong through-the-cycle returns.

The way in which we use real estate can also shift over time. For example, the pandemic accelerated the growth of online retailing, having opposing impacts on industrial and retail shopping centre sectors. Over the past year, industrial and logistics sector returns reached their highest level on record, significantly outpacing inflation. This can be contrasted with shopping centre retail returns, which were challenged by pandemic-related issues and compounded by structural longer-term shifts in online retail growth.

Economic growth: During some economic downturns, real estate has shadowed the negative performances of equities and bonds. During the early 90's and Global Financial Crisis (GFC), the financial recession revealed severe asset mispricing and created liquidity challenges. Both inflation and real estate returns declined through this period.

However, in an economic recovery, real estate returns and values typically grew in conjunction with the rebound in inflation. The inflationary growth that has transpired over recent quarters has resulted from the dramatic economic recovery underway. If post-recession recovery is like those in the past, then overall real estate returns should grow with inflation. The chart below illustrates the relationship between property returns and inflation; when there is growth in inflation, property returns also rebound.

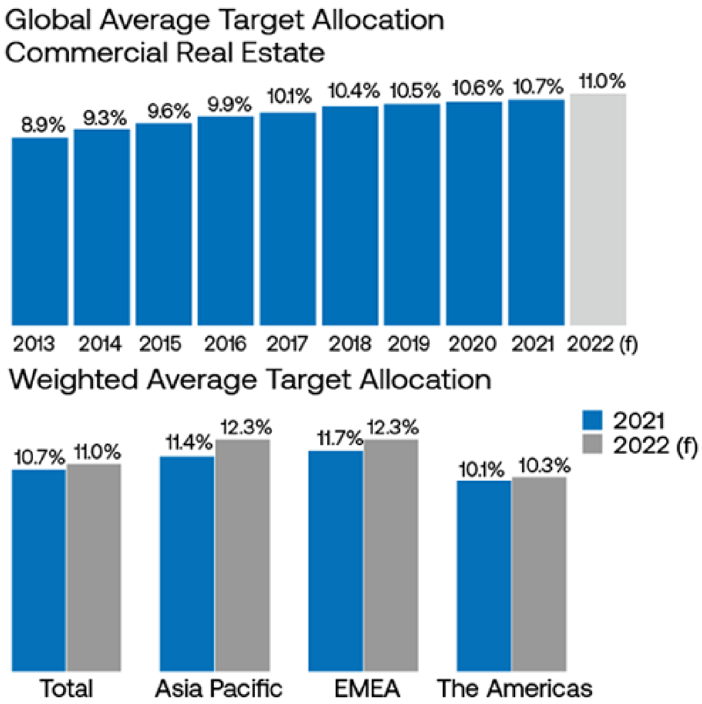
CPI and Unlisted Total Sector Returns (Office, Retail and Industrial & Logistics)



Source: MSCI, ABS, Charter Hall Research

Allocations to real estate

This economic recession didn't originate from the financial sector. As such, the real estate sector didn't face the same issues relating to liquidity and the underlying confidence in asset valuation seen during past economic crashes. The global allocations to real estate, particularly across the Asia-Pacific region, continued to increase over the past year. This generates increased investor demand for commercial real estate assets across Australia.



Source: MSCI, ABS, Charter Hall Research

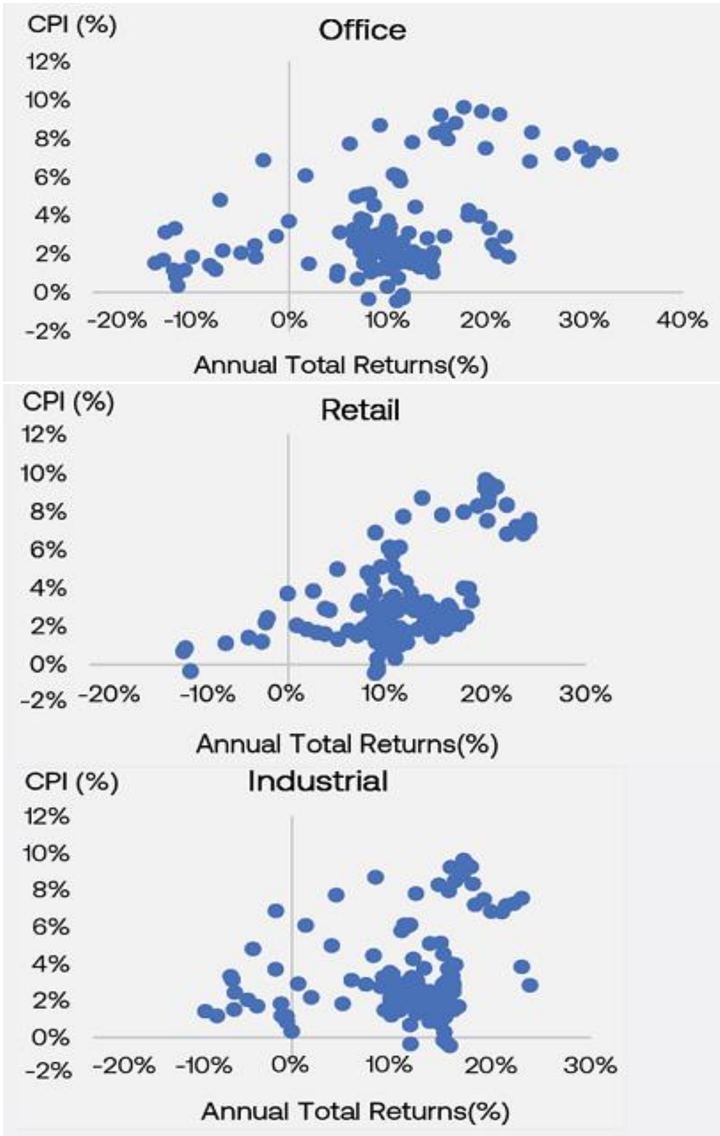
Inflation and commercial property

Real estate provides low correlation to other investments such as hedge funds, venture capital, private equity, private debt and other hard asset classes such as infrastructure[1]. As such, investors have sought real estate for the potential benefits of reducing volatility and potential risk.

These factors have already translated into increased investor demand. Investment volumes in Australia across the industrial sector reached $18 billion over the year – well above the long-term average of $4.7 billion. Similarly, transaction volumes for the Office sector climbed to $15.9 billion over the past year, the highest level since 2019.

How has commercial real estate performed in periods of elevated inflation?

The charts below show how in periods of higher inflation you tend to find the annual returns of commercial real estate to also be high and elevated. This is a reasonably consistent relationship regardless of the underlying property sector.



Commercial Real Estate has historically provided a solid hedge and performed well in periods where inflation increases against the backdrop of economic expansionary periods. As noted above though, other external market factors can also have larger influences on investment performance, including investor demand.

Outlook

Moderate inflation poses little risk to commercial property. We focus on strategies that assist in offseting the potential negative impact of rising inflation, including a focus on long leases with fixed reviews, interest rate hedging and high quality assets.

Steven Bennett is Direct CEO and Sasanka Liyanage is Head of Research at [Charter Hall Group](), a sponsor of Firstlinks. This article is for general information purposes only and does not consider the circumstances of any person, and investors should take professional investment advice before acting.

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1. (PERE 2022) Look Ahead 2022 : Five reasons real estate allocation will rise next year.
Charts show quarterly returns between the periods of 1985 and 2021.
Source: MSCI, ABS, Charter Hall Research

Four big ideas in the small cap space

Steve Johnson

New COVID variants, tech stock bubbles bursting, supply chain disruptions, higher inflation hurting companies and consumers, the winding down of quantitative easing and the prospect of higher interest rates in the year ahead.

You can forgive investors for entering 2022 with a sense of dread. It's been an eventful couple of years and the future (at least for now) seems even less predictable than before.

Even against this backdrop, investors who have tracked a standard index during this time have likely achieved three consecutive years of strong returns. And while we don't make many friends among our fellow active fund managers for saying this, at Forager, we're big fans of index funds. They're an attractive, low-cost way of investing in the world's largest and most predictable businesses.

But therein lies the issue: because these stocks are so well covered by research analysts and because there is so much money chasing them, it can be tough for active fund managers to beat the market.

The case for small caps

Not so at the smaller end of the market, though.

Sifting through thousands of small companies with little to no brokerage coverage as well as a lack of media and market interest, the active investor can add value. We find that the more volatility and the more uncertainty, the more value that can be added.

Last year, for example, professional stock pickers shone in a time when it seemed active management had been all but left for dead. In the US, early returns from Bloomberg suggested that 85% of small cap managers beat the Russell 2000 index in 2021.

It's true that small companies are usually less resourced and are, therefore, more sensitive to negative news headlines, market sentiment and economic downturns. But don't let that scare you. There's a lot of potential and some big ideas in the small cap space, and here are four reasons why.

1. A much larger universe

By looking beyond the big names on the major indexes, investors will find a much larger universe with thousands of opportunities.

While our international analysts have more than 10,000 stocks to choose from, our Australian investment universe comprises roughly 400 ASX-listed stocks that meet the criteria we invest against. You still need to pick the right ones, of course, but contrast that with a manager trying to invest $10 billion in large caps. They're only left with about 40 Australian stocks in which to make a meaningful investment.

2. More opportunities to diversify

A larger universe lends itself to more variety and opportunities. Look a little closer and investors will find that there is more diversity in terms of the types of businesses on the market.

Large companies typically have more diverse revenue streams and any new initiatives pale in significance relative to existing businesses. If you like Facebook founder Mark Zuckerberg's plans for the metaverse, I can guarantee investors will find a small company that is a much 'purer' bet on the same idea – we think of it like a sports boat versus a cruise liner.

One example is NASDAQ-listed Fathom Holdings, a tech-driven real estate services platform held in our International Shares Fund. Have you ever wondered why the modern real estate agency even bothers with a physical store? Buyers do all of their research online and meet the agent at the property ... simple. These days, many large real estate agencies have begun slowly adapting by cutting their office spaces. But Fathom *began* as a digital native, and that's why it has attracted more than 7,000 agents to its platform in less than a decade. The theme is fairly obvious, but only in small cap land can you receive pure exposure to it.

Our Australian Shares Fund has its largest investment in a company that only does cloud-based mining software. That's a niche alright. But it's an attractive niche because it doesn't draw too much competition and there is still plenty of room for growth in an industry that has been relatively late to adopt the latest and greatest in software. A large fund manager can invest in something huge like SAP, giving it a tiny exposure to the theme. On the other hand, a small and nimble investor can back RPM Global and be fully rewarded if they are right.

3. The law of large numbers

One of the most overlooked laws in investing is what's called 'the law of large numbers'. Eventually, large companies get so big that they begin struggling to meet their growth targets, though that hasn't stopped some companies from trying in the past. In any case, nothing can grow faster than the global economy forever.

Small caps typically have longer runways and that can be a good thing for investors. While they're still small, they can grow and expand their operations more quickly and can, in some cases, bulk up through mergers and acquisitions. This means there's a lot of potential yet to be capitalised on.

Take Australian tyre distributor National Tyre, for example. We bought this stock in 2019 at $0.40 per share. During the COVID crisis, National Tyre bought one of its largest competitors. In one attractively-priced acquisition, it doubled the size of the business and more than doubled its profits. Today, the stock trades at $1.50 (though we sold ours too soon).

Many large companies make acquisitions, but the bigger they get, the harder it is to find something that moves the dial, and that's when many make mistakes.

4. Volatility is your friend in the stock market

Perhaps the most attractive aspect of the smaller end of the stock market is wild gyrations in share prices. Being well covered and widely owned by index funds, the share prices of larger companies tend to be a lot more stable. Not so in recent times. Facebook owner Meta recently saw its share price fall 25% after releasing its results, which was one of the largest falls ever seen in large cap land.

For small cap investors, moves of that magnitude barely rate a mention.

National Tyre's share price halved after we first bought it, falling from $0.40 to $0.20 and rising sevenfold from there. And in the last 18 months, Fathom Holdings' share price has been absurdly volatile, going from $10 to $50 and back to $12 again.

This sort of volatility scares a lot of investors. But for those with a longer time horizon, it can be of benefit. Along with a share price rollercoaster, Fathom has more than doubled the size of its business and is likely a better investment today than when we first bought it. You rarely see these sorts of bargains at the big end of town.

Volatility delivers opportunity

While we can't speak for other active managers, we like the case for small cap stocks, especially at a time like this. In our experience, when markets are volatile, it can be a great time to find investments in quality businesses at reasonable prices. And if the outperformance managers experienced in 2021 suggests anything, it's that the small cap space holds a world of untapped potential.

Steve Johnson is CIO at Forager Funds, a Sydney-based boutique fund manager skilled in finding opportunities in unlikely places. This article provides general information to help you understand our investment approach. It does not consider your personal circumstances and may not be suitable for you.

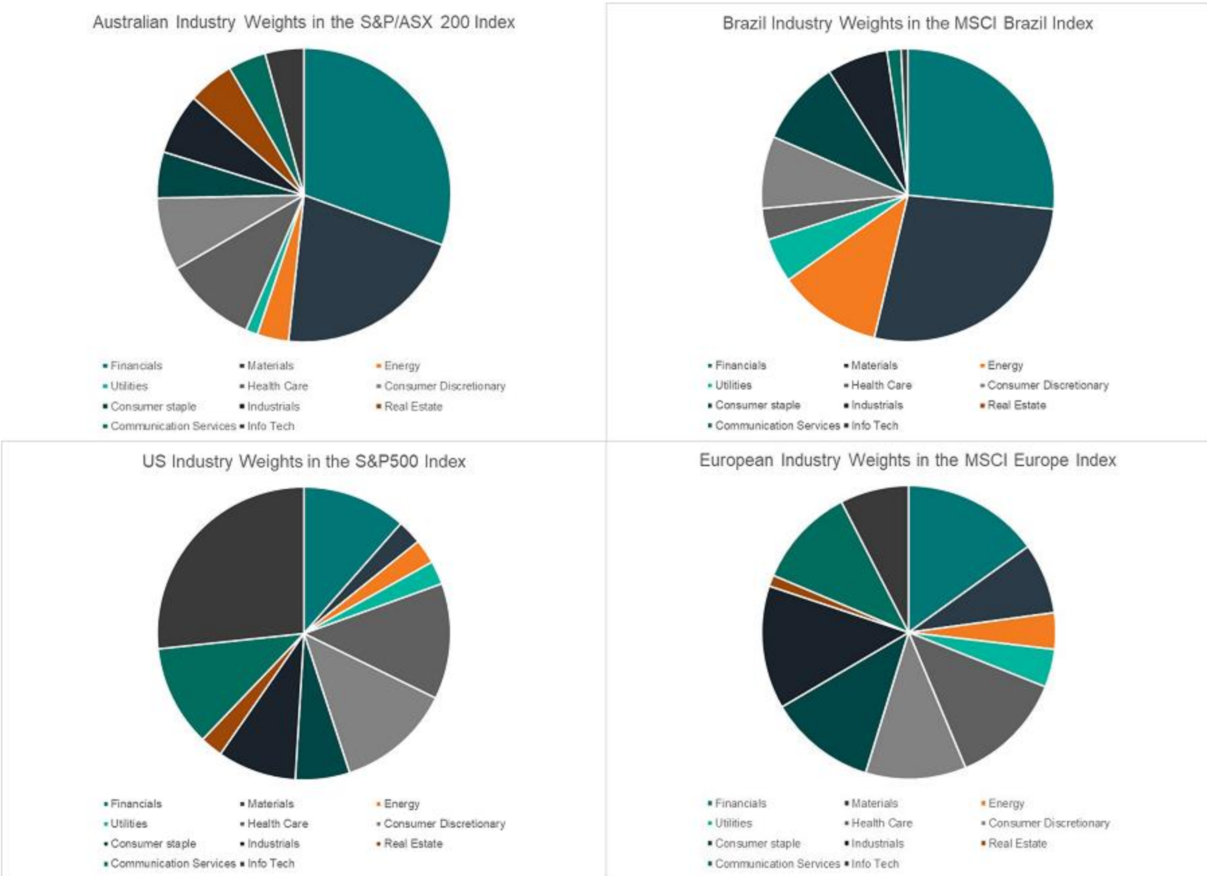
Australia is at a crossroads and must support new ideas

Chris Gibson

Australia boasts one of the most stable and developed economies in the world. This prosperity has been built on a sometimes fortuitous blend of strong population growth, minerals, vast agricultural tracts and plentiful energy in the form of coal and gas.

These capital hungry sectors have been well-fed by a large financial services sector. Despite contributing just 0.3% of the global population, Australia is home to five of the 50 largest banks in the world by market capitalisation.

So it is not surprising that Australia's economy shows a material weighting to these 'traditional' industries, much more so than in the USA and Europe. In fact, the makeup of the stock market benchmark, the S&P/ASX 200, arguably resembles that of a developing nation, more so than our larger Western peers.



Evolution, not revolution

So, how do we continue not only growing our economy but ensure it evolves to remain competitive on the global stage? Our international peers have a more balanced economic structure with technology, communications services and biotechnology representing much larger parts of the business community than in Australia (while acknowledging CSL as a global leader).

We need to take the opportunity presented by this economic moment in time to innovate within our current driving industries, while fostering a business, policy and economic environment that supports the impactful industries of tomorrow

The spending floodgates are open, let's channel this to the growth engines of the future

With the Federal and State Governments and the Reserve Bank of Australia on their respective spending sprees, there's an opportunity to not only underpin progressing businesses, but to invest in the sectors that represent long-term economic growth opportunities, particularly health care and technology.

Firstlinks
a Morningstar company

Technology could involve either software or 'mechanical' advancements that drive efficiency or better environmental and social outcomes for society.

In the last three years, the technology sector has grown strongly in Australia, led by companies such as the Afterpay, Xero, Canva, Airwallex and Culture Amp among many more being valued at over $1 billion. While these organisations are not be as big as their US counterparts (Facebook, Apple, Amazon, Netflix, Google etc), they demonstrate that Australia is home to some impressive tech talent. Moreover, they highlight the opportunity Australia has to support smaller-scale tech companies out of the gate, investing in the next wave of impactful business ahead of the curve.

Industries including renewables and technologies such as artificial intelligence will likely have application not only in a renewed domestic manufacturing sector, but it will support other areas of future growth, such as aged care, which is undergoing transformation and improvement.

Refreshing the commercial approach to the political hot button of climate and renewable energy would yield impactful medium-term productivity, more so than postulating over climate targets.

Supportive regulatory and taxation structure will be vital to drive growth

Investing in our growing sectors should ensure that companies continue their growth trajectory in Australia, while fostering a supportive growth environment will encourage other entrepreneurs to innovate here.

Some of the measures introduced in the May 2021 Federal Budget can help businesses to support innovation in specific sectors, including health and technology. For example, the 'patent box' will ring-fence earnings from patented medical and biotechnology innovation. These will be concessionally taxed at 17% and taxpayers will be able to calculate the decline in value of eligible intangible depreciating assets (for example copyrights, patents registered designs and in-house software).

This means taxpayers can better align tax outcomes with the life of intangible assets while encouraging research and development activities in growing sectors. Although not applicable until 1 July 2023 onwards, businesses still have the temporary full expensing regime in the meantime.

Furthermore, the Modern Manufacturing Initiative (MMI) announced in the October 2021 Federal Budget will start funding projects with a second round of grants worth $50 million set to roll out.

On a local scale, sectors are transitioning at an exciting rate, with the Geelong carbon fibre and composites manufacturing precinct setting an interesting example. A collective effort between policymakers, industry and higher education institutions, it aims to transform an automotive icon to a resource powerhouse following the closure of the Ford manufacturing plants in Geelong and Broadmeadows in late-2016.

Create the frameworks that foster innovation

With so much of the country's economic prosperity hinged on commodity and property prices, it makes sense from a risk perspective to ensure other sectors are supported to diversify the nation's economic growth.

If our past successes have hinged on factors with exposure to commodity prices or currencies, we need a hedging strategy for those times when prices aren't so buoyant. The balancing act lies in creating policy to support emerging industries without disenfranchising staple industries that continue to provide employment and significantly contribute to the country's GDP.

As a country with relatively stable economic, political, and financial environments, Australia can compete more on the global stage by fostering innovation in our biggest sectors, while supporting newer industries to mature. But such large-scale transformation can't be done in silos.

It is imperative that we see collaboration between policymakers, higher education institutions and industry, on a renewed commitment to championing diversity in economic support and success. We sit at an economic inflection point that could allow Australia to shore up its economic standing in a new and exciting way. Despite the turbulence of the last 18 months, Australia does have a bright future, but it'll be brightest with innovation at its core.

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