Firstlinks
a Morningstar company

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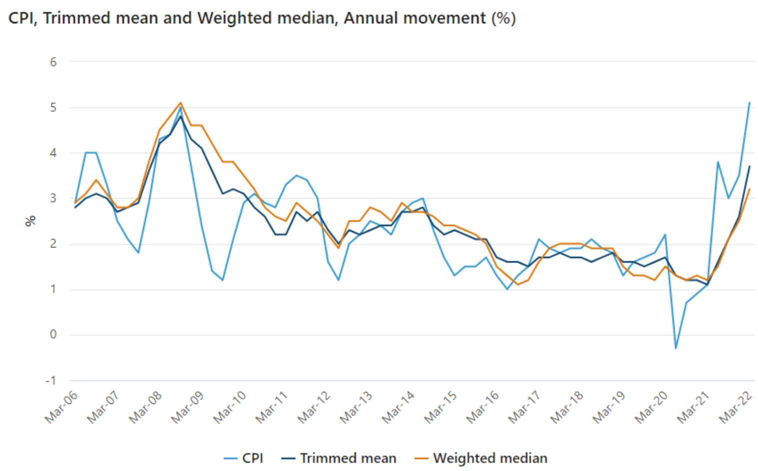
Editorial

Yesterday's higher-than-expected 'trimmed mean' inflation rate of 3.7% and the coming higher interest rates will test the resolve of investors who focus on the long term in their share portfolios. The **Reserve Bank Governor** has waited too long to tap the brakes on the cash rate, with his preferred measure of inflation now well outside the target 2 to 3% range. He was so confident that inflation was under control that he berated traders for pricing in rate increases, and now the questions are May or June and by how much. Some borrowers who relied on Philip Lowe's oft-stated view that cash rates would not rise until 2024 will pay the penalty for not fixing at around 2% last year.

The list of negatives for the market continues to lengthen ... global growth forecasts downgraded this week by the IMF, a 20-year high inflation result, the end of easy monetary policies, the rise of autocratic powers, geopolitical risks in the Pacific, reduced globalisation amid supply blockages, surging energy prices ... and both sides of Australian politics handing out stimulatory spending to contradict the aims of tighter monetary policy.



It's useful to remind ourselves at times like this of the words of **Howard Marks of Oaktree Capital** which we summarised previously in this article:

- The world is more uncertain today than at any other time in our lifetimes.
- Few people know what the future holds much better than others.
- Investing deals entirely with the future, meaning investors can't avoid making decisions about it.
- Confidence is indispensable in investing but too much of it can be lethal.
- The bigger the topic (world, economy, markets, currencies and rates) the less possible it is to achieve superior knowledge.
- Our decisions about smaller things (companies, industries and securities) have to be conditioned on assumptions regarding the bigger things, so they, too, are uncertain.

I agree with Marks which is why I rarely make market forecasts in these pages, but I broke my rule in December 2021 when I wrote:

"However, while I recommend anyone with a long-term investment horizon should stay substantially invested in equities, I am starting to reduce some equity exposures as I personally believe the market will experience a decent fall sometime in 2022."

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It is often said that the first casualty of war is the truth, and we also know that the first winner in elections is hypocrisy. Both sides are guilty, with minor point-scoring and a fear of saying anything of substance that might alienate a voting block. Claims and counterclaims on taxes, cashless credit cars, visas, Medicare, energy costs, climate change and wages. The media encourages the farce by reporting numbers and promises with little critical analysis.

The hypocrisy meter crossed the red line when **Scott Morrison** said:

"The Labor Party is frightening the pensioners about something that is a complete and utter lie."

Plenty of form here. The Liberals were doing their own scary work in March and into April on Facebook and Instagram. If this is not an attempt to '*frighten the pensioners*', what is?

Labor has its own versions, with **Anthony Albanese** jumping on the proposal to appoint **Anne Rushton** as Health Minister and a comment she made seven years ago, claiming she:

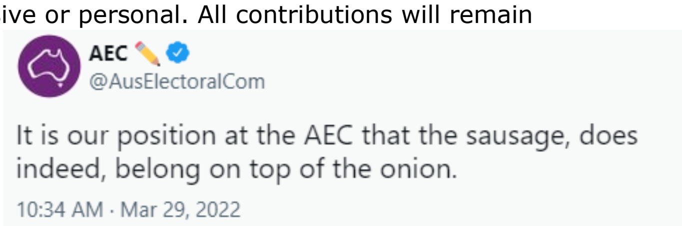
"... has made it very clear that, if we have an election of the Morrison Government, we will see more cuts to Medicare, more cuts to Medicare over the next three years".

This point-scoring actually generates the wrong type of points, with **The Australia Financial Review/Ipsos** poll finding this week:

"Both Mr Morrison and Mr Albanese are tied at a record low 42% in terms of overall competency, the lowest level for either a prime minister and Opposition leader in 27 years."

This week, in our **[Reader Survey]**, we'd like to find out what you think are the major issues, who will win, who you will vote for and any other points you wish to raise. Results will be published next week, as well as comments, provided they are constructive and not abusive or personal. All contributions will remain confidential.

At least the **Australian Electoral Commission** manages to keep a sense of humour about a great Aussie tradition.



With interest rates likely to rise in the next month, and the bank bill rate already above 0.5%, there is a prospect of savers actually generating some income from cash soon. Take a look at the rate on your savings and you can see why bank share prices have been rising. The table below is the rate schedule on my SMSF's main transaction account. The rates will not rise at the same speed as cash rates while increases are passed on in loans. It's good for margins. I have sat on the Pricing Committees of three banks over many years and across the tens of billions in these accounts, the Reserve Bank actions will feed into commercial bank profits.

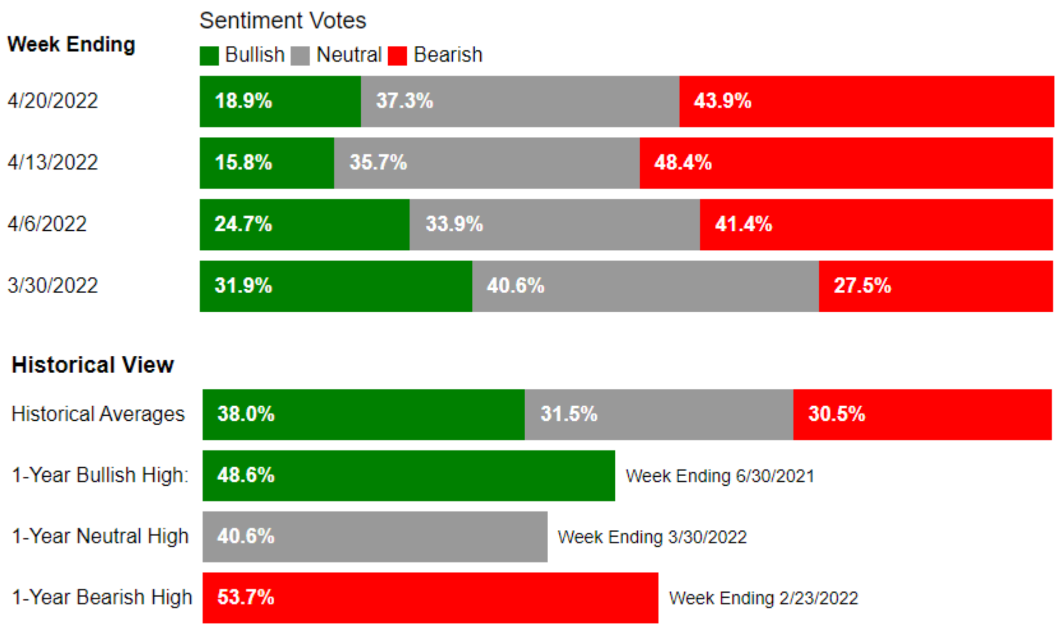
Your Credit Interest Rate Summary

Date	Balance	Standard Credit Interest Rate (p.a.)
11 Apr	Less than $10,000.00	0.00%
	$10,000.00 - $19,999.99	0.00%
	$20,000.00 - $49,999.99	0.00%
	$50,000.00 - $99,999.99	0.00%
	$100,000.00 - $249,999.99	0.00%
	$250,000.00 - $499,999.99	0.00%
	$500,000.00 and over	0.10%

Note. Interest rates are effective as at the date shown but are subject to change.

Regardless of how much we focus on Australia for our own investments, it is the US market which sets the tone for all others (it comprises 56% of the market cap of global stock markets). Even if you do not invest directly in the US, it's worth knowing how US investors view the market. A long-term data source is the **American Association of Individual Investors (AAII)** Sentiment Survey, which provides a spreadsheet of sentiment data since 1987. The 'percent bullish' was the lowest last week that it had been since 1992.

Direction Members Feel The Stock Market Will Be In The Next 6 Months?



So although investors are sitting on mountains of cash, inflation, recession, war and rates are playing on their minds more than ever.

This week, I use the example of **Hyperion Asset Management,** a recent Morningstar Fund Manager of the Year, to look at the dilemma facing investors when a leading manager with a strong 20-year track record hits a rough short-term patch. As **Warren Buffett** said: *"The stock market is a device for transferring money from the impatient to the patient."*

Graham Hand

Also in this week's edition ...

Picking up on the inflation theme, **Tim Davies** says Russia's invasion of Ukraine will trigger a long bout of sustained inflation that will impact commodity and food prices and keep inflation high over the next decade.

Also on inflation, **Russel Chesler** believes a global inflationary environment will see the Australian sharemarket, dominated by miners and value shares, outperform the US as commodities soar.

ESG. A topic that was once considered niche is now an enduring component of the investment decision-making process. **Evan Reedman** covers the fundamental investment approaches and strategies that consider ESG.

Ahead of Berkshire Hathaway's annual meeting on Saturday, **Lewis Jackson** looks back on the Oracle of Omaha's latest letter to shareholders. It's full of lessons for investors, including waiting for value, keeping a buffer, trusting the quality of your investments and recognising new and important trends.

Finally, **Blair duQuesnay** explains 'inception date roulette' and warns that any financial adviser presenting you with a beautiful chart of past performance is a red flag.

Our white paper this week is from **Franklin Templeton** on the performance of equity and other asset class allocations in the wake of recent geopolitical events.

A full PDF version of this week's newsletter articles will be loaded into this editorial on our website by midday.

Lessons when a fund manager of the year is down 25%

Graham Hand

"I used to rule the world
Seas would rise when I gave the word
Now in the morning I sleep alone
Sweep the streets I used to own

I used to roll the dice
Feel the fear in my enemy's eyes
Listen as the crowd would sing
"Now the old king is dead! Long live the king!"

One minute I held the key
Next the walls were closed on me
And I discovered that my castles stand
Upon pillars of salt and pillars of sand …"

Extract from Viva la Vida by Coldplay

Selecting an active fund manager who can outperform the market over time is even more difficult than picking stocks. A talented and skilful team may utilise a style which goes out of favour for many years, making the fund managers look below average. Investors may become frustrated with the poor performance and leave at the worst time, attracted to last year's successes.

Similarly, previous winners can go through rough patches. Many of Australia's best-known fund managers, such as Hamish Douglass at Magellan, Andrew Clifford at Platinum, Roger Montgomery at Montgomery and Anton Tagliaferro at Investors Mutual, have struggled to match their benchmarks after fees in recent years.

Zero to hero

Consider the performance of the Lazard Select Australian Equity Fund since 2019, shown here. Its highly-regarded and experienced investment team carries a strong Silver rating from Morningstar, yet in both 2019 and 2020, it was in the bottom percentile of its category of Australian Equity Large Value (and Value also underperformed Growth). Almost last among over 100 managers surely tested the resolve of investors and analysts alike. It recovered somewhat over 2021, and in 2022 YTD, the fund is in first place, as well as in the top few over 12 months. Going from last to first in a year or two says a lot about the fortunes of fund managers.

Total Return %	2019	2020	2021	YTD
Investment	12.43	-10.75	17.21	15.84
Category	18.43	-1.47	18.28	4.18
Index	23.84	1.83	17.79	3.13
Quartile Rank				
Percentile Rank	99	99	60	1
# of Invest. in Cat.	107	108	102	100

Source: Morningstar Direct

A study of the 2021 Fund Manager of the Year

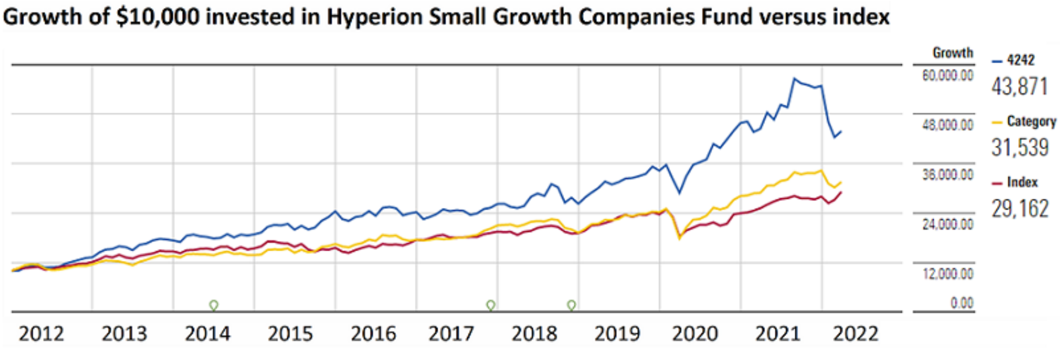
It works both ways.

In February 2021, Morningstar announced its 2021 Fund Manager of the Year awards, and Hyperion Asset Management was not only selected as the Overall winner, but also topped the separate categories of Domestic Equities – Large Cap and Domestic Equities – Small Cap. Morningstar said:

"Our 2021 winners have proven themselves to be excellent stewards of fund shareholders' capital. Australian investors are well served by a solid lineup of quality managers, but Hyperion Asset Management wins our Overall Fund Manager of the Year award for a strong performance across all their stable of funds."

A check on the long-term performance of the Hyperion Small Growth Companies, which scores a rare Gold fund rating from Morningstar, shows why the investment team is held in high regard. Over the 10 years to 31 March

2022, the fund returned 14.6% per annum against its index (Morningstar Australia TME GR AUD) of 10.5%. Over five years, the comparison is 13.1% versus 9.6%. In the chart below, the blue line shows the Hyperion fund versus the red line of the index.



However, in the first quarter of 2022, the fund was down 20% versus the index up 4.2%. Investors have given back a quarter of their capital relative to the index in only three months.

What lessons do the recent results versus its history give investors about selecting active managers?

Warnings in the Morningstar analysis

Writing in September 2021, Malcolm Malseed, Associate Director at Morningstar explained the Gold rating:

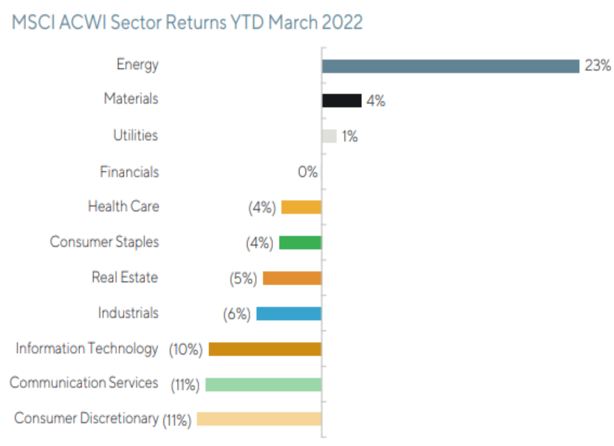
"Hyperion Small Growth Companies continues to earn our highest conviction among growth-focused small-cap managers given its deep and differentiated research, genuine long-term time horizon, and highly experienced portfolio managers."

Then in explaining the investment process, the reasons for recent underperformance appear:

*"Hyperion pays **little heed to benchmark weights** when constructing a concentrated portfolio of high-growth small-cap stocks. Importantly, portfolio outcomes are a function of bottom-up research and forecast long-term internal rates of return, rather than any top-down or macro thematic. Nevertheless, this approach leads to large sector skews relative to the index and peers. Technology names have traditionally dominated, accounting for more than **34% of the portfolio as of 31 July 2021 compared with the benchmark's 8%** and category average of 13%. Top holdings as at that date included software-as-a-service providers Xero and Wisetech Global. Consumer cyclical is the second-largest sector exposure at just over 30%, comprising names such as Dominos Pizza, Temple & Webster, and Kogan. Healthcare stocks also prominent through exposures such as Fisher & Paykel Healthcare, Nanosonics, and Pro-Medicus. Hyperion typically holds **no allocation to materials and energy stocks**, reflecting its lack of confidence in the sectors' earnings predictability and pricing power." (my bolding).*

The technology and growth stock exposure which served Hyperion well in 2020 and the first half of 2021 reversed as the market became increasingly focussed on rising interest rates. Investors turned more towards resources and energy stocks, supercharged by the Ukraine war and a shortage of commodities.

This table of sector returns in the MSCI All Country World Index for the first quarter of 2022 shows it was almost impossible for a fund without exposure to energy and materials (resources) to match its index.



Source: S&P Capital IQ. For the year-to-date period ending March 31, 2022.

Any fund manager measured against an index with significantly different stock weightings will produce outsized volatility when the market changes.

Therein lies the challenge for investors. Morningstar considers the Hyperion team one of the best but a first-time investor on 1 January 2022 has seen a 25% underperformance. The results from selecting an active fund manager often require patience. In some cases, managers can spend years underperforming with no change in their process or the people making the decisions that once placed them top of the league tables.

Hyperion's global fund in the listed market

For investors who prefer to invest via the listed markets, Hyperion's Global Growth Companies ETF (ASX:HYGG) has been on the ASX since 22 March 2021. Its March 2022 fund update shows unfortunate timing, delivering a nil return versus the benchmark of up 12.2% over 12 months. The same portfolio in managed fund form has an inception date of 1 June 2014 and has returned 19.4% per annum versus the benchmark of 13.2%.

The major winners and losers over the 12 months are shown here. Some initial COVID beneficiaries such as PayPal, Spotify and Facebook (Meta Platforms) have given back much of the prior gains.

In an updated review of this fund written on 22 April 2022, Morningstar's Malseed reported under the heading '*Backing long-term winners but patience is required*':

"... a strong growth-style bias will likely see short-term bouts of underperformance during cyclical or value-led rotations. Investors should be prepared for higher-than-average volatility."

Top 5 Contributors and Detractors (rolling 12 months)

Contributors	Price change (%)	Avg Weight (%)	Contribution to return (%)
Tesla Inc.	63.6	12.3	5.6
Microsoft Corporation	32.6	6.9	1.5
Costco Wholesale Corp.	65.7	2.4	1.0
Alphabet Inc. Class A	36.8	5.1	0.9
Amazon.com, Inc.	6.9	8.7	0.7
Detractors	**Price change (%)**	**Avg Weight (%)**	**Contribution to return (%)**
PayPal Holdings, Inc.	-51.7	6.4	-2.9
Spotify Technology SA	-42.8	4.1	-2.6
Roku, Inc. Class A	-61.0	3.1	-2.0
Block Inc. Class A	-39.4	7.8	-1.7
Meta Platforms Inc. Class A	-23.4	5.1	-1.4

Here is the price performance of HYGG since listing, and with a 12-month price range of $3.32 to $4.98, the investor experience depends on the entry point. Over April 2022, the price has fallen from $3.92 to $3.38 at the time of writing (27 April).

What do Lazard and Hyperion tell us about active managers?

Hyperion's first Australian equity funds were launched in 2002, giving it a 20-year track record. An investment of $100,000 in its Australian Growth Companies Fund in September 2002 would have increased to $918,547 by 31 March 2022 (net of fees with distributions reinvested) versus the S&P/ASX300 at $577,076.

It's well established that most active fund managers do not beat their benchmarks after fees over time. It is common to see strong periods of outperformance when a style works well, but markets rarely reward a particular style forever. The 20 years is an impressive test period which shows evidence of skill rather than luck.

Where does this leave investors?

I am not a fund or stock analyst, and I have no intention of second-guessing my colleagues at Morningstar who spend their careers judging manager performance, but here are my takeaways:

1. Allocating to an active fund manager is a long-term decision

As Warren Buffett said, "*The stock market is a device for transferring money from the impatient to the patient.*"

There is no point paying active fees for a fund manager who hugs the index, and so investors should pay for skilled managers who back their views and run large tracking errors. These stock views may take years to pay off. Investors who jump out after a bad few years are likely to be leaving at the wrong time. A decision to place confidence in an active manager should come with at least a five-year horizon, and better, eight to 10 years.

2. Investors must have realistic expectations

Consistent outperformance will not occur over all time periods. Markets always face surprises and geopolitical events are difficult to forecast. Few people expected Russia to invade Ukraine and send commodity prices surging. A fund manager such as Hyperion who is unimpressed by the lack of certainty of earnings in the resources sector will suffer in current markets, at least over the short term. Lazard's traditional value approach struggled for years. Investing can face a long disappointment before a thesis pays off.

3. Funds may be vulnerable after a hot streak

A manager that has done well for many years and continues to hold the same stocks probably manages a portfolio that has become more expensive over time, absent evidence its companies are increasing earnings. This so-called 'Price/Earnings expansion' occurs when investors become more confident about long-term prospects and are willing to pay more for each dollar of earnings. Prior to the current monetary tightening phase, the fall in interest rates also encouraged this expansion. But markets change, rates are rising, and there is likely to be some reversion to the mean after a hot streak.

4. Watch for style changes

Fund managers who experience a period of underperformance may feel pressure to change their stock selection process. Many a value manager who suffered through a decade of growth stocks winning and a move to tech felt the challenge and criticism of sticking to traditional, boring industrial companies.

It's an obvious reaction to judge the quality of an investment by its success, or what is known as 'outcome bias'. A good outcome always looks like a good investment, but an unfavourable outcome may be due to bad luck in a rapidly-changing world, rather than a fund manager's investment process being fundamentally weak.

There should be a uniform and consistent message

Hyperion advises on its website:

"Our funds are designed for investors with a long-term investment outlook, so we recommend looking at 10-year performance where available to appropriately assess growth prospects.

Convention has Hyperion's portfolios benchmarked against the relevant equities indices. This is something we acknowledge for the sake of reporting but studiously ignore when it comes to making investment decisions."

Exactly right. It was a lapse to highlight the short term when on 29 July 2020, Hyperion issued a media release headed "*Hyperion Asset Management top performer over two decades".* Fair enough. Every fund manager on earth would be proud of this achievement and use it to promote their funds.

But then Managing Director and Chief Investment Officer, Mark Arnold said,

*"Our performance demonstrates that it is possible to take a long-term view and deliver **short-term** results with the same fund, growing our investors' money through **lean times and bountiful**. We design our portfolios in a way that allows us to **consistently** profit from market highs as well as to **protect capital** during periods of market volatility. Our results prove that you do not need to use complex hedging strategies and derivative products to protect your capital during downside movements." (my bolding)*

While the time frames assumed in this comment are relevant, losing 20% to 25% in a quarter does not meet the test of '*protecting capital*'. Hyperion went on to quote data compiled by S&P in its SPIVA report on Australia that:

" ... over the 10- and 15-year periods, 83.9% and 85.30% of Australian equity general funds underperformed the S&P/ASX 200 on an absolute basis respectively. The findings demonstrate that Hyperion is one of a very small group of managers able to consistently outperform over the short and long term."

Perhaps Hyperion does not consider one year to be short term, but many investors would. Here are the one-year and three-year results sourced from their website as at 31 March 2022.

Hyperion funds net performance versus index

Fund	**1 year**	**3 years**
Global Growth Companies Fund	-12.2%	+4.8%
Australian Growth Companies Fund	-10.9%	+5.9%
Small Growth Companies Fund	-11.9%	+2.5%

Mark Arnold went further, describing a "*strict proprietary investment process which allows the team to separate the winners from the losers.*"

Does 'separated' mean the losers are avoided? Roku (down 61%) or PayPal (down 52%) suggest otherwise, and a stock that falls 50% needs to rise 100% to recover the loss.

Hyperion should be well satisfied with the results delivered over two decades but they should temper their claims to reflect a style which will inevitably deliver periods of underperformance that may last at least a year, and probably longer.

Take it away, Coldplay

The final verse of Viva la Vida is a warning that the market can bring every investor down to earth. Even when the investment process is not built "*upon pillars of salt and pillars of sand",* those who want to be king need to prepare for a period when the monarchy is unfashionable.

"Revolutionaries wait
For my head on a silver plate
Just a puppet on a lonely string
Oh who would ever want to be king?"

Graham Hand is Editor-at-Large for Firstlinks. This article is general information and does not consider the circumstances of any investor. Disclosure: Graham owns a small investment in the listed HYGG.

Extracts from Viva la Vida by Coldplay. Copyright, Universal Music. The concert recorded live in Sao Paulo, Brazil, is extraordinary. The song reached Number One on the Billboard 100 and UK Singles Chart and won Song of the Year at the Grammy Awards in 2009.

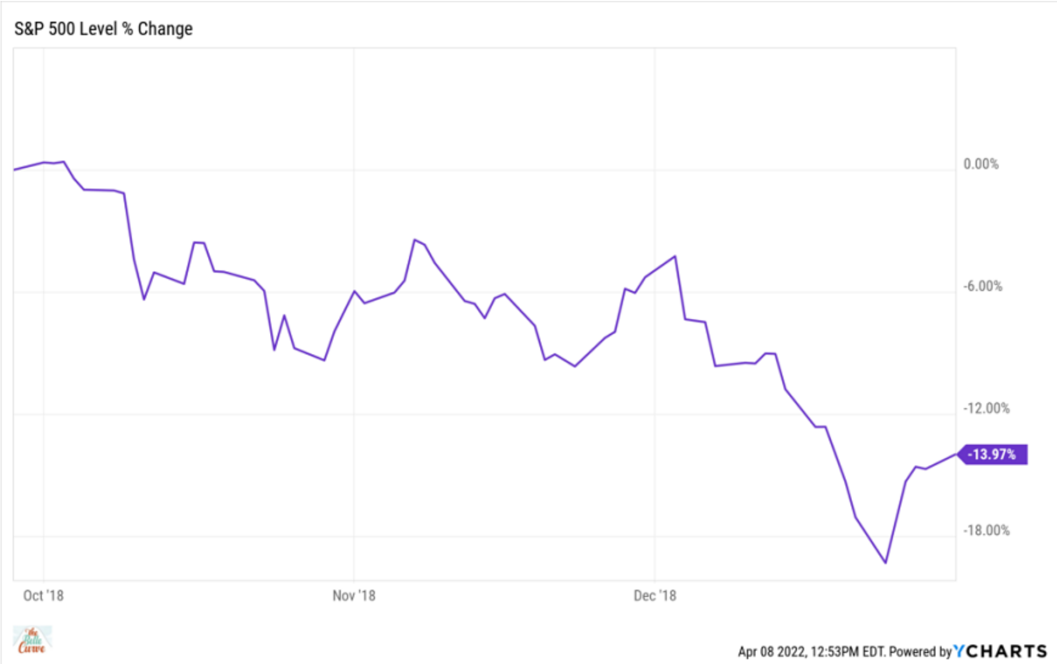
Investment performance and start date randomness

Blair duQuesnay

I've been the primary adviser to clients for 12 years, and my career in wealth management is approaching two decades. Each client hired me on a different date over those 12 years, and since I joined RWM four years ago, this has been at a pace of about one new client every month. As a result, they all have different start dates for calculating investment performance under my watch. I call this 'inception date roulette'. There's an element of randomness that determines what the first few months or years of the client's experience will be in terms of performance since the inception date. I never know when the next downturn in the market will be, but I am certain that a new client will hire me right before it.

Remember in 2011, when the S&P rating agency downgraded the debt rating of the U.S. government? Congress had a standoff over the debt ceiling at the time. Stocks sank 16% over a two-week period. I had just moved from New York to New Orleans and founded a solo advisory business. Guess when my first new client signed on? July 2011. We began that relationship with double-digit declines in their portfolio.

Remember the 20% market decline leading up to Christmas Eve in 2018? The chart below shows the S&P 500 Index performance during the fourth quarter of that year.



I joined RWM in June of 2018 and spent the first few months learning about our firm's systems, processes, and investment strategies. By the time I began talking to potential new clients, it was late summer. It takes about a month or two from the time we have an initial conversation with a prospect to the time accounts are opened and funded. My first few new relationships were established right before the market sank 20% that fall.

We all remember the COVID crash of March 2020. The market fell 35% in six weeks. That was the most intense market decline I've ever experienced. One client joined in early February 2020, immediately before the world shut down.

There's a flip side to inception date roulette, the client who gets lucky with their timing. Our phones were ringing off the hook during that Covid spring. I chose to cut my maternity leave short to help with the volume. As a result, a handful of clients started in April and May of 2020. In our first year working together, the S&P 500 was up 44%.

My point here is that our investment philosophy and strategy remained the same over these time periods. We didn't become geniuses in April 2020, and we weren't idiots in October 2018. These are simply moments in time when the market moved in one direction or another. When it comes to your inception date with an investment advisor, chance plays a huge role.

The same goes for investment strategies going in or out of favour. As I pointed out recently, Warren Buffett, the greatest investor of all time, has had multiple, prolonged periods of underperformance. His style was out of favour, but he stuck to it. And once again, he is reaping the rewards of his discipline. Berkshire Hathaway stock is up 18% year to date while the market is down 5%. So too does any investment style go in or out of favour. Ours is no exception.

I am forever grateful to my mentors for teaching me never to sell based on past investment performance. This might work for hedge fund managers, but it's a recipe for disaster for wealth managers. I have always thrown cold water on excitement over recent outperformance because I know the next downturn is lurking around the bend.

Advisers who sell on performance, die by performance. Their client relationships will not endure the next downturn or the next time their strategy underperforms. Any financial adviser presenting you with a beautiful chart of past performance is a red flag. An advisory relationship should be based on so much more than investment performance alone. If you've taken the time to find the right adviser for you, by vetting their philosophy, process, and people, you will be prepared for whatever chance throws your way in the early part of that relationship.

Blair duQuesnay, CFA®, CFP® is an investment advisor at Ritholtz Wealth Management, LLC. For disclosure information please visit: https://ritholtzwealth.com/blog-disclosures/. Republished, with permission, from The Belle Curve.

Australian shares outperform the US as commodities soar

Russel Chesler

Australian shares are outperforming the US sharemarket amid a rally in commodities. This is pushing up the big miners on the Australian Securities Exchange (ASX) while the technology-heavy US share market has fallen hard this year on higher bond yields. VanEck expects this trend to continue through 2022 given higher commodity prices are likely to persist and support the local market even as bond yields rise, which is hitting US shares harder than local shares.

The 10-year Australian government bond yield has jumped over 3% and could climb to 3.5% in the short term with strong inflationary expectations being priced into bonds. US inflation surged to a new four-decade high of 8.5% in March from a year earlier, driven up by skyrocketing energy and food costs, supply constraints and strong consumer demand. The yield on the 10-year Treasury has climbed close to 3%. The 10-year Australian government bond yields could continue to rise, given inflationary pressures have been exacerbated by higher energy prices and wage costs too are likely to rise if the unemployment rate falls below 4%, which is expected by the central bank.

While the local market hasn't been hard hit by rising yields, the US market, with its heavy representation of growth shares, has been dented. Over the year to 22 April, the Australian share market has easily outperformed the S&P 500 and the NASDAQ, rising by 1.9%, compared to falls of 9.5% for the S&P 500 and 17.3% for the Nasdaq Composite Index. That means the ASX 200 has outperformed the benchmark US index by around 11 percentage points this year. The local market has been buoyed by resources giants BHP and Rio Tinto, whose prices have risen with commodities, particularly iron ore and coal. Commodities work as a hedge against inflation, and they are clearly rising with inflation this year.

Time for value to shine

VanEck expects that Australian shares could continue to outperform those in the US given that inflation is also higher in the US than in Australia, with the local Consumer Price Index sitting at 5.1% in the first quarter of 2022. In addition, the nation's largest companies are the big miners and other 'value' shares which are relatively more resilient to inflation and higher bond yields.

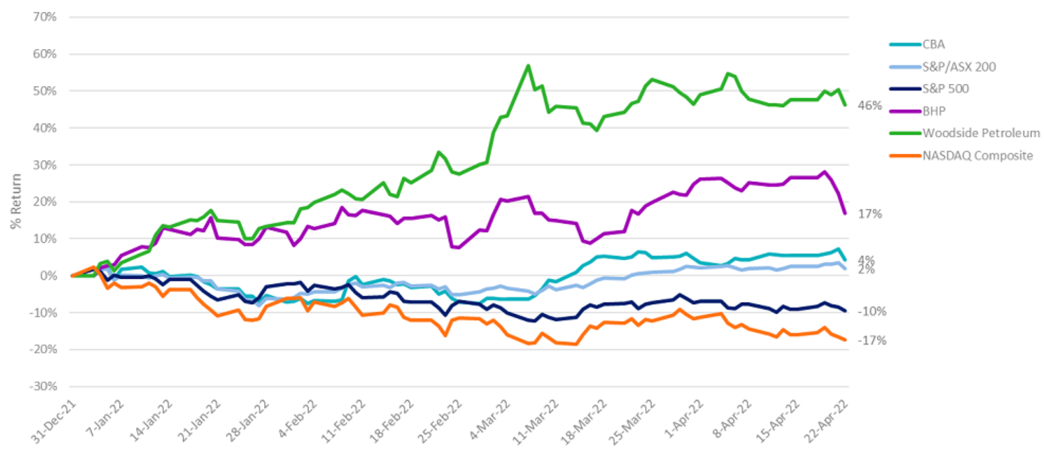
As the US market is heavier with technology and other growth companies, it is more vulnerable to higher bond yields than the Australian share market, which has benefited from higher commodity prices. The S&P 500 is dominated by global technology companies like Amazon, Apple, and Microsoft, which have higher price/earnings (P/E) ratios and more growth expectations built into them, that is, they rely heavily on expectations of future earnings for their current valuations. The value of a company's stock is the sum of all of its expected future earnings. Future earnings are discounted using a long-term interest rate to estimate their current value. So rising bond yields have dented the value of technology companies in the US in recent times; they are worth less now than just a few months ago when bond yields were lower, hence the hard fall in the tech-heavy Nasdaq this year and also the S&P 500. Shares in Netflix, for example, have been smashed by higher bond yields in recent times. The company lost US$54 billion in market value in one day alone, after it reported a surprise decline in its subscriber base.

In contrast, "value stocks" such as the big Australian miners, are more resilient to higher bond yields. They are companies that are currently profitable, but have low to moderate growth expectations, so therefore, relatively low price-to-earnings multiples. Higher bond yields are much less of a problem for the big miners and other value stocks since they are less expensive to begin with, compared to pricier technology companies, whose prices have been hurt by higher yields.

Supporting the local market's outperformance, shares in oil exporters Woodside Petroleum and Santos are higher by 46.2% and 29.2%, respectively, over the calendar year to 22 April, while BHP and Rio Tinto have gained by 16.8% and 13.5%, respectively. They are doing well in spite of, or because of higher inflation.

The big banks, which are cyclical, also tend to do well in a rising interest rate environment, as it allows them to increase their margins. We have seen CBA trade near all-time high levels towards $110/share in recent times despite higher bond yields pushing up its funding costs. CBA shares are higher by 4.3% over the year to 22 April, compared to the overall Australian share market which is up 1.9% as measured by the S&P/ASX 200. Investors need to be mindful that with higher interest rates there will likely be downward pressure on asset prices and credit growth.

Performance of select companies and indices



Source: Bloomberg, data is YTD to 22 April 2022. Past performance is not a reliable indicator of future performance.

This inflationary environment is conducive to further gains by the big miners and other value shares on the ASX. Australian companies that can maintain or increase their prices, and therefore margins, without turning away customers, will be the winners as inflation shoots higher. And they could be winning more profits and earnings than shares in the US which could be hit harder by higher bond yields and even higher levels of inflation as commodity prices rise.

So, after many years of underperforming, 2022 could finally be the year that Australian shares outperform the US market.

AUD on track to US80¢

VanEck also expects the Australian dollar to gain in value, despite its current dip on Chinese Covid-19 lockdowns. We believe it is headed towards 80 US cents this year, rising with commodity prices. That is a good thing for local companies buying imported goods as it will help to contain inflation of goods priced in US dollars.

And with the CPI much higher in the US than in Australia, there could be more pain for company profits in the US than for Australian companies as costs there potentially rise more quickly than here.

But a rising currency also means that investors may want to consider hedging the currency exposure on their offshore investments. While a falling Australian dollar amplifies returns from foreign investments, a rising Australian dollar against the US currency will eat into returns from investments denominated in US dollars once their value is converted back into local currency. So, for investors who have previously left their investments unhedged, now may be the to time consider some level of currency hedging.

Russel Chesler is Head of Investments and Capital Markets at [VanEck](), a sponsor of Firstlinks. Russel is responsible for managing VanEck's Australian ETFs. This is general information only and does not take into account any person's financial objectives, situation or needs. Any views expressed are opinions of the author at the time of writing and is not a recommendation to act.

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Reader Survey on the Federal election 2022

Firstlinks

The plans and policies for the future of Australia, as presented on the campaign trail, look like more of the past. The major parties offer minor differences in a campaign dominated by handouts, personality attacks and gotcha moments.

At a critical time in history, with a disastrous conflict in Europe, disruption to global supply channels and inflation at the highest since the introduction of the GFC, there are no policies that address permanent structural budget deficits and we are told to 'prepare for war' with our major trading partner.

What are the issues that really matter in Election 2022?

Please take our quick six question survey. What bothers you, who will win, how will you vote?

All answers are confidential and we will publish the results and comments (subject to a health and sanity check) next week.

Access the online survey here.

Three waves to keep inflation high over the next decade

Tim Davies

The Russia-Ukraine conflict looks set to splinter the world into two distinct trading and financial systems that are aligned across the US and Chinese axis, triggering a long bout of sustained inflation that will impact commodity and food prices over this decade. This inflation will come in three waves: rising energy prices, repositioning commodity supply chains and the birth of a new reserve currency.

Before we get into it, we'd like to make it explicitly clear to readers that we do not in any way support military conflict. War is horrible and the wrong action regardless of who is involved. Our role as investment analysts is to remain as neutral as possible. This position allows us to correctly assess the contribution of parties directly involved in the lead-up to this conflict, as well as assess the long-term consequences that are likely to evolve.

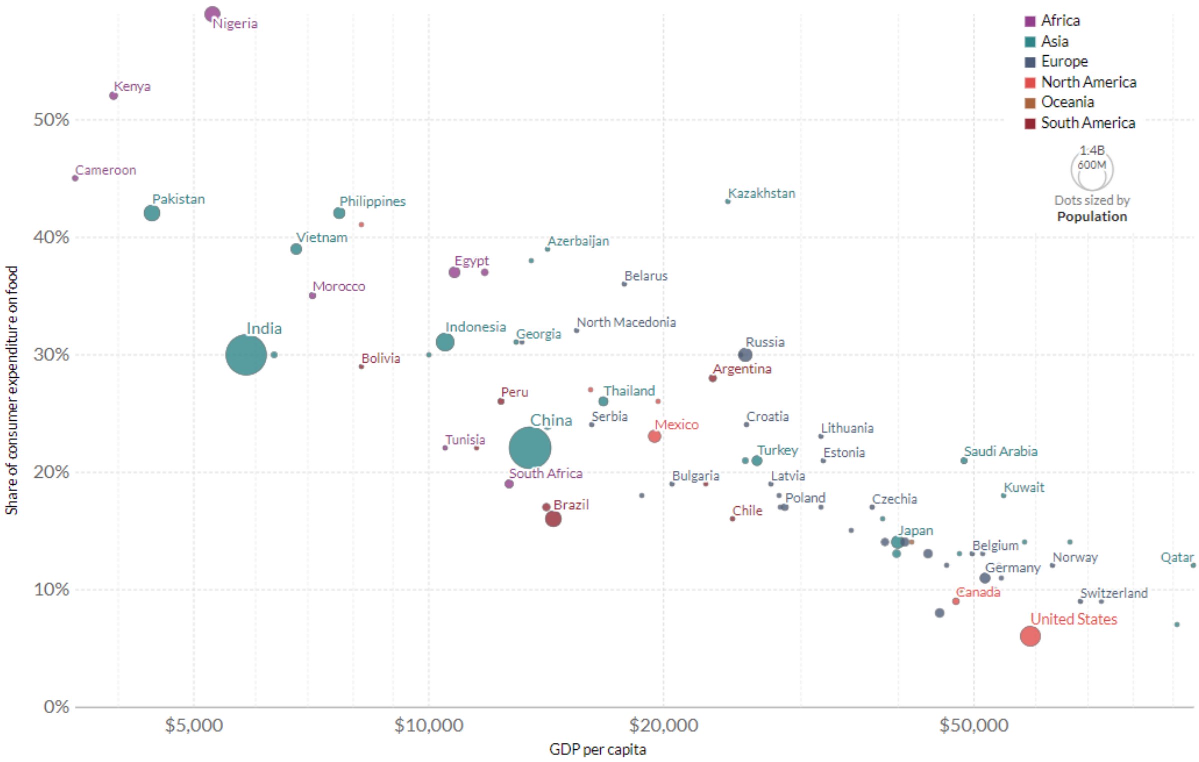
1st wave: Rising energy prices

The cause of the first layer of inflation starts from an imbalance between the supply and demand of energy in the form of oil and natural gas. The last sustained global inflationary period occurred as a direct result of the 1973 Arab-Israeli Yom Kippur War and the 1979 Iranian revolution, which led to a 13-fold oil price increase from US$2.70 in 1973 to US$36 in 1980. Then US Federal Reserve chairman Paul Volker was forced to raise US interest rates to 19% in 1981.

Fast forward to the 21st century, and we see rising demand from the developing world, which is expected to grow its share of global oil demand from 40% in 1990 to 70% in 2030. However, with many of the largest oil fields reaching maturity, and with US-led sanctions on major oil reserve nations like Iran, Venezuela, Iraq and now Russia, the rising oil price volatility witnessed over the past 20 years is likely to worsen.

The consequence of higher sustained energy prices over the past two decades has led to higher prices across the entire supply chain for goods and services. Higher food prices, which depend upon stable oil and gas prices to manufacture fertilizers, plant and harvest crops, fuel logistics networks, refrigerate supermarkets and for cooking, impact consumers in the developing world the hardest. Food prices have doubled since 2017, likely driving food costs above 50% of income across most developing countries.

Percentage of GDP per capita spent on food, 2017 ($USD)



Source: Our World in Data

The recent war in Ukraine has triggered a big jump in food prices. Together, Russia and Ukraine's share of global exports is 32% for wheat, 19% for corn and 80% for sunflower oil. Russia and Belarus together supply 40% of potash while China and Russia supply over 50% of global phosphate, both critical to the production of fertilizer that is used to lift crop yields in agriculture. Further complicating supply constraints is the recent introduction of food export bans from Argentina (Soybean and meal), Algeria (all food products), Indonesia (palm oil), Ukraine (barley, sugar, wheat), Serbia (grains and oils) and China (fertilizer).

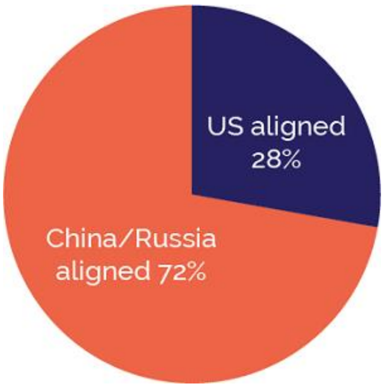
Lower global food supply risks further increase in grain and livestock prices, with wheat and corn up 50% and 20% respectively since February 1st. Higher energy prices are also expected to raise the cost of logistics and manufacturing globally, raising the cost of almost all goods and services for the consumer.

All this data almost certainly means that inflation is here to stay.

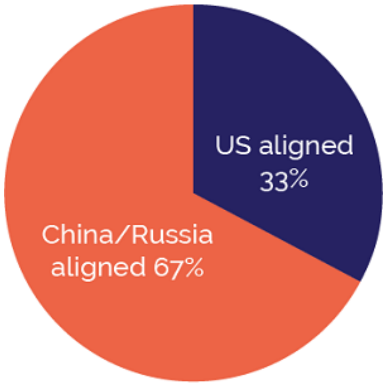
2nd wave: Repositioning commodity supply chains

The 2nd inflationary force will be driven by the massive costs associated with shifting commodities production away from Russia, as well as other countries that appear to be aligning against the US. This group includes the 39 countries that voted either against or abstained from voting in the recent United Nations efforts to sanction Russia following its actions in Ukraine. Also included are Saudi Arabia, the UAE and Brazil, who have each made public statements against direct sanctions on Russia.

Political alignment of global oil reserves, March 2022



Political alignment of global gas reserves, March 2022



This should set off massive alarm bells for US aligned nations, including Australia and most of Europe. With 72% of global oil reserves located in countries that are aligned with China and Russia, the ability of Western nations to shift their oil resources towards friendlier nations is severely limited. Over one third of US aligned resources are the Canadian tar sands, which produces three times more global warming pollution than conventional crude oil, while another one-quarter of these resources are found in Kuwait, which is surrounded by China/Russia aligned partners Iraq, Iran, and Saudi Arabia.

Global natural gas reserves are also heavily aligned with China and Russia supporting countries, which together control 67% of global reserves. Almost 40% of US-aligned gas reserves are in the South Pars field of Qatar, which is split 50/50 with Russia-aligned Iran. Efforts to shift Europe's natural gas reliance away from Russia towards US shale gas is also unlikely a long-term solution given the US only holds 5% of global gas reserves.

The location of oil and gas reserves in countries aligned with China and Russia will require a massive increase in investment, measured in the trillions of dollars, to identify and develop new commodity resources. Besides exploration and production costs, substantial infrastructure investment will also be required for pipelines, mine site development, roads, ports, and shipping. While the shift to renewable energy sources will alleviate some of these concerns over the next few decades, building them will require substantial fossil fuels to mine the necessary resources and manufacturing.

Massive long-term investment also needs to be undertaken for many other commodities including fertilizer (potash and phosphorous), copper, aluminum as well as food production and water. Unless Europe and the US can find common ground and alleviate their multi-decade fight with Russia and now China, the cost of developing replacement resources will drive substantially higher resource prices and inflation for consumers over the long term (>10 years).

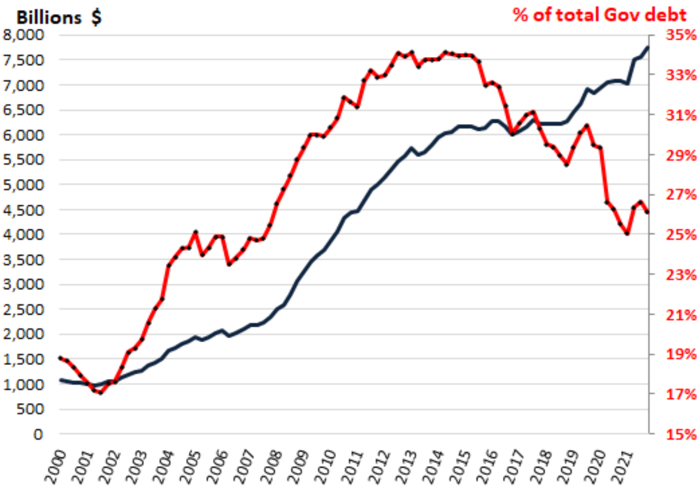
3rd wave: A new reserve currency is born

The third and largest force that is likely to trigger long-term inflation is the acceleration in the shift away from the US dollar as the reserve currency of the world towards an alternate China-aligned reserve currency.

This shift away from the US dollar picked up in 2014 when traditional buyers of US Treasury bonds, led by China and Japan began to reduce their exposure to US government bonds. Foreign holders' share of US government debt fell to 26% in 2021, a 16-year low.

Efforts by the US Federal Reserve to artificially hold US treasury interest rates below 2%, while accelerating artificial money creation through its 13-year 'temporary' Quantitative Easing support program, led to the high inflation and the loss of purchasing power on capital invested in these bonds.

US Gov't debt held by foreign holders, quarterly ($USD)



Source: Wolf Street

Firstlinks
a Morningstar company

Rather than raise interest rates or lower government spending, the US Federal Reserve Bank instead chose to purchase US debt on its own balance sheet which has grown from US$800 billion in 2008 to almost US$9 trillion in 2022. In addition, removing the requirement for US commercial banks to include their exposure to US treasury bonds when calculating Basel III leverage ratio limits, has allowed the banks to increase their holdings by US$1.8 trillion since April 2020, reaching a record US$4.8 trillion in March 2022.

The massive accumulation of US debt can be traced back to the US Federal Reserve's decision to maintain a low-interest rate policy through Quantitative Easing. China first raised its concerns over the US dollar in 2009, when then People's Bank of China governor Zhou Xiaochuan called for a new reserve currency "disconnected from individual nations and able to remain stable in the long-run".

Tensions have risen substantially following recent moves by the US, Japan, and Europe to prevent Russia from accessing more than US$300 billion of its foreign exchange (FX) reserves[1] following its actions in Ukraine. Such a strong move has never been undertaken against a single country before and sets a dangerous precedent that any country unwilling to support the US can have its FX reserves confiscated. For the many regions of the world that have been directly impacted by military action from US-aligned countries across South-East Asia, India, Africa and the Middle East over the past 50 years, the lack of alignment in the consequences of military action looks to be the proverbial straw that broke the camel's back.

Over US$12 trillion is held in FX reserves by the top 20 reserve holders in the world, with 53% of this value held by counties aligned with China or Russia. These countries, particularly China with US$3 trillion reserves, will almost certainly shift more assets like gold bullion, while Bitcoin may also begin to attract some sovereign interest, given the current commodity supply concerns and high prices through much of the next decade, it's also likely that these countries will use these reserves to stockpile essential commodity resources like oil, copper, nickel, and possibly rare earth elements.

Last month Russia and China formally announced plans to launch an alternate reserve currency backed by a basket of currencies and commodities including gold. Most of the work on this Stable Depository Right (SDR) basket has already been completed, with a first draft of the policy expected within the next few weeks. This SDR basket will initially include the other four members of the Eurasian Economic Union (EAEU), Armenia, Belarus, Kazakhstan, and Kyrgyzstan. Its success could see it quickly extend further to include the additional 14 members of the Shanghai Co-operative Organization (SCO) that would bring the large and rapidly growing economies of India, Pakistan, Turkey, Qatar, and Saudi Arabia on board.

Finally, it is also reasonable to expect that the 145 countries participating in China's One-Belt-One-Road (OBOR) will also look to settle their trade in a stable and neutral currency that an SDR would provide, without the threat of confiscation from a single country.

The shift to a multipolar world now looks to be a certainty, with the world splitting along a US vs China axis. Important elements to consider in this discussion are the distribution of populations, global debt, and major commodity resources across each axis.

If we begin with population distribution, we see that countries that aligned with Russia or abstained in the recent Ukraine vote at the UN, plus those who publicly refused to enact sanctions on Russia (Saudi Arabia, UAE, Mexico, and Brazil), accounted for 60% of the world's population in 2020. If we add the SCO nations to the mix, we surpass 70% of the world, while the addition of OBOR takes us closer to 90%.

Next, looking across the location of key commodities, we see that dominance between each axis rests slightly with the China axis, which has more resources in iron ore, potash, cobalt, platinum group metals (PGM) and rare earths.

Worth noting is that while the US currently has dominance across 4 of the 10 key resources

Political alignment of global resources, March 2022

Global Resource %	US-aligned	China-aligned
Iron Ore	28%	72%
Copper[1]	65%	35%
Nickel[2]	60%	40%
Gold	50%	50%
Silver[3]	70%	30%
Potash	40%	60%
Cobalt	30%	70%
PGM	5%	95%
Rare Earth	10%	90%
Lithium[4]	88%	12%

1 – Chile 23% global copper reserves, 2 – Indonesia 19% nickel, 3 – Peru 19% gold, 4 – Chile – 52% Lithium listed above, in each case its lead rests on a single country that is also a member of the OBOR trade union. If a China-axis reserve currency was more widely adopted by the OBOR members, we would see all the ten global resource reserves aligned with the China axis. The fall of the US dollar as the sole reserve currency will likely lead to an accelerated loss of its purchasing power, especially priced against hard assets like gold, silver and other commodities. Bitcoin should also benefit from the same US dollar devaluation.

Finally, if we next look at global external debt, we see that the top 20 countries hold a combined liability of US$80 trillion. Remarkably, just 4.7% of this external debt value is held by countries aligned with the China axis (China, India, Brazil, and Russia), which makes them at less risk from rising inflation and the eventual need to raise interest rates. With 95% of this debt held by the heavily indebted countries across Europe as well as the US, global investors will eventually demand higher interest rates to compensate for the risk of default, or alternatively shift their assets towards safer investment opportunities.

Investors take notice

The world is at an enormous crossroads that needs to be carefully considered by investors to ensure their assets are best positioned to manage what will certainly be a volatile period over the next decade. While the military conflict between Russia and Ukraine is unacceptable, the heavy-handed response from US-aligned central banks has forced the hand of government's representing almost 60% of the world's population to accelerate the shift away from the US dollar acting the only reserve currency. Unfortunately, the genie is now out of the bottle and cannot be put back in.

Hard commodities like gold, silver, energy, and other resources should be primary beneficiaries from the three waves of inflation outlined above. Bitcoin also stands to benefit greatly from the decline in the purchasing power of the US dollar.

[1] *Foreign exchange reserves are the financial assets of country held offshore in the form of currencies, bonds, equities, and/or commodities to facilitate international trading and used support the value of their own currency during financial crises.*

Tim Davies is Director of Research at Holon Global Investments. This article contains only general financial information and has not taken into account your personal circumstances.

Beyond the acronym, navigating important ESG choices

Evan Reedman

The investment community loves a TLA (three letter acronym) and after years of dominance, the ever-popular ETF (exchange-traded fund) has been overtaken in the acronym lexicon by 'ESG'.

Interest from investors, advisers, institutions, and regulators alike has brought Environmental, Social, and Governance (ESG) investment considerations to the fore over many years. A topic that may have once been considered a niche or fad is now an enduring component of the investment decision-making process.

There is no shortage of examples that underscore why there is an increasing focus on the E, S and G outcomes of financial investments. In recent years, significant Australian weather events have added a dimension of lived experience to environmental considerations. Social justice movements around the globe have increasingly posed complex questions about the role of companies in driving equity. And the real-world impact of corporate governance issues has taken the topic out of the boardroom and into the headlines.

The breadth of issues demonstrates the broad scope of this catch-all acronym, which is made more complex when you consider the broad spectrum of investors driven by a range of deeply held personal views and individual investing goals.

Investors may be seeking to align their investments with their personal values on any number of issues or to address ESG risks that could impact long-term investment performance. For existing investors, this may mean looking at an existing portfolio seeking to understand where ESG fits, or considering making changes. For newer investors, ESG factors may be actively considered in the establishment of an investment plan and the associated investment decisions.

With all the variability represented by these three letters, clarity for investors begins with an understanding of the fundamental investment approaches and strategies that consider ESG matters.

Advocacy and investment stewardship

A key practice that isn't limited to funds with a stated ESG strategy is advocacy and investment stewardship - which involves utilising share ownership to advocate for strong corporate governance on ESG-related issues. Primary activities include engaging with company boards and executives and voting on resolutions at annual general meetings. These efforts are aimed at ensuring companies disclose significant ESG risks, develop strategies to reduce them and report on progress - ultimately holding them accountable for practices that protect long-term shareholder value.

ESG integration

This more broadly defined method refers to a process where investment decisions are informed by an assessment of financially material ESG information. Primarily used by active fund managers to identify the risk or potential of a company, perhaps identifying an attractively priced and well performing energy company who is thoughtfully managing the transition to sustainable resources.

Exclusionary portfolio screening

As the name suggests, exclusionary screening involves excluding certain securities, industries or sectors from a broader investment. The exclusions are typically based on specific ESG criteria- for example, a global equities fund that excludes all companies that manufacture tobacco or weapons.

Inclusionary portfolio screening

On the flip side inclusionary screening, or proactive investment, directs investment towards companies that have higher ESG ratings relative to industry peers or other investment opportunities. Inclusionary investing could also involve targeting whole sectors that meet certain ESG criteria.

Impact investing

This strategy centres on targeting investments with dual objectives of supporting positive social or environmental outcomes while also generating a financial return. For example, a green bond where the proceeds are used to help the company make its manufacturing processes more energy efficient.

With an understanding of these approaches and their different applications, investors and advisers are equipped to consider ESG within a broader financial plan. In doing so ESG becomes a part of the process of weighing key investment considerations alongside other familiar fundamentals including goals, cost, diversification, risk and potential return.

Capable investment managers will continue to provide product options that address the increasing appetite for ESG investing, and while this could provide more options that reflect the diverse goals of investors more choice can bring a degree of complexity.

While investors will always benefit from carefully considering the available options, a product versus product comparison can never take the place of a clear understanding of how you want your own values and goals to be reflected in your investments.

Evan Reedman is Head of Product at Vanguard Australia, a sponsor of Firstlinks. This article is for general information and does not consider the circumstances of any individual.

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Buffett on markets, cash and seizing opportunities

Lewis Jackson

Editor's Note: Ahead of Berkshire Hathaway's annual meeting on Saturday, we look back on the Oracle of Omaha's latest letter to shareholders. It's full of lessons for investors, including waiting for value, keeping a buffer, trusting the quality of your investments and recognising new and important trends.

Warren Buffett published his 57th letter to Berkshire Hathaway shareholders in late February. He discussed market valuations, the company's US$144 billion pile of unspent cash and how America's largest owner of infrastructure assets is positioning itself for environmental sustainability.

The letter came as Berkshire Hathaway (BRK.A) reported net income had more than doubled to US$89.9 billion in 2021, driven by strong results at its utilities and railroad holdings.

After lagging the S&P 500 index in 2020, Buffett's conglomerate edged out the benchmark last year as its dozens of banking, insurance, energy and industrial subsidiaries rode the resurgence in value stocks amid the post-covid economic recovery.

Berkshire shares finished the year up 29.6%, compared to a 26.9% for the index. Outperformance has extended into the new year, where Berkshire Hathaway is up 4.8% versus a 10.2% decline for the index.

Buffett uses the annual letter to update shareholders on the company's performance, but it's read by legions of investors eager to hear his take on world events.

Here are 5 takeaways for investors.

Berkshire pips the S&P 500

Source: Morningstar

Little value on offer for the world's famous value investor

Buffett defended Berkshire Hathaway's $144 billion in unspent cash saying low-interest rates had pushed up prices for everything from stocks to oil wells and limited worthwhile spending opportunities.

"Berkshire's current 80%-or-so position in businesses is a consequence of my failure to find entire companies or small portions thereof (that is, marketable stocks) which meet our criteria for long-term holding," he said.

Investing in the company's portfolio of businesses was preferable to acquisitions currently, Buffett said, while acknowledging the firm's cash file was too large to be spent just internally. Looking across publicly traded markets, Buffett and long-term partner Charlie Munger saw "little that excites".

With few attractive external opportunities, Berkshire has spent billions buying back its own stock. In addition to the $51.7 billion spent in 2020 and 2021, the conglomerate made another $1.2 billion in share repurchases through 23 February this year.

Buffett also warned investors to be on the watch when companies use "deceptive 'adjustments'" to report earnings, saying "bull markets breed bloviated bull."

Always maintain a margin of safety

Buffett spoke of the value of keeping cash on the books. He pledged to keep US$30 billion in the coffers at Berkshire to ensure the company would always be "financially impregnable" and never need to depend on the kindness of strangers. Raising money in an emergency, in other words.

"Both of us [Buffett and Munger] like to sleep soundly, and we want our creditors, insurance claimants and you to do so as well," he said.

Buffett is no stranger to picking up a distressed bargain. During the depths of the Global Financial Crisis in 2008, he threw Goldman Sachs a US$5 billion lifeline in exchange for equity. The bank redeemed the shares in 2011, netting Buffett US$3.7 billion in profit.

Jump when the valuation is right

One of the "four giants" that power Berkshire Hathaway is its wholly-owned stake in BNSF, one of the US' largest freight railroads. Buffett decided to takeover BNSF one day after markets ditched the company's stock in the aftermath of disappointing earnings.

BNSF's share price shed 10% in the days following its third-quarter report on 22 October 2009. A little under two weeks later, Buffett lobbed a US$26 billion bid. Last year alone, the railroad posted a record US$6 billion in profit.

"BNSF, our third Giant, continues to be the number one artery of American commerce, which makes it an indispensable asset for America as well as for Berkshire," Buffett said.

Quality wins out

Berkshire Hathaway's collection of banks, insurance companies, utilities and industrials benefited from the recovery in value stocks over the course of 2021.

In addition to its wholly or nearly wholly-owned stakes in insurers, railroads and utilities, the firm also holds parts of Apple, American Express, Mitsubishi, Chevron and a $7.6 billion stake in Chinese electric automaker BYD that it bought for $232 million in 2008.

"We own stocks based upon our expectations about their long-term business performance and not because we view them as vehicles for timely market moves. That point is crucial: Charlie and I are not stock-pickers; we are business-pickers," he said.

Stronger economic growth and the prospect of higher interest rates helped value stocks stage a recovery last year. Value investors look for stocks trading at prices they believe to be below fundamentals. The Morningstar US Large Broad Value returned 33% last year compared to a loss of 3% in 2020. It's growth equivalent notched 36%.

Berkshire Hathaway's top 15 largest equity holdings

Name	Ticker	Percentage of company owned
American Express	AXP	19.9%
Moody's Corporation	MCO	13.3%
Bank of America	BAC	12.8%
U.S. Bancorp	USB	9.7%
The Coca-Cola Company	KO	9.2%
The Bank of New York Mellon	BK	8.3%
BYD Co	2594	7.7%
Mitsui & Co	8031	5.7%
Apple	AAPL	5.6%
ITOCHU Corporation	8001	5.6%
Mitsubishi	8058	5.5%
Verizon Communications	VZ	3.8%
General Motors	GM	3.6%
Charter Communications	CHTR	2.2%
Chevron Corporation	CVX	2.0%

Source: Berkshire Hathaway filings.

Renewable investments on the rise

Buffett touted the environmental performance of Berkshire's most polluting holdings as the conglomerate flagged further investments in clean energy across its utility portfolio.

Two of Berkshire's biggest holdings, wholly-owned railroad BNSF and its 91% stake in Berkshire Hathaway Energy (BHE), a collection of utilities and energy infrastructure companies, generated 90% of the conglomerate's direct emissions.

In a separate letter, Buffett's anointed successor Greg Abel, outlined plans for BHE and its subsidiaries to invest or finance US$37 billion in clean energy projects. BHE also plans to invest billions in energy storage and transmission. Railroad BNSF plans to cut greenhouse gas emissions by 30% in 2030, relative to 2018 levels.

"Berkshire will have failed if BHE and BNSF do not achieve their GHG [greenhouse gas] emissions reduction goals," said Abel.

Greater renewable energy investment across the conglomerate sits alongside Berkshire's US$4.5 billion stake in oil and gas giant Chevron. Buffett defended Chevron at the annual general meeting last May, saying the company had "benefited society in all kinds of ways".

Lewis Jackson is a reporter/data journalist at [Morningstar](), owner of Firstlinks. This article is general information and does not consider the circumstances of any investor. This article was originally published in Morningstar on 2 March 2022.