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Editorial

"*Bring it on*!" That's what many investors looking for income are thinking. Although media coverage focusses on the coming plight of borrowers who entered the property market in recent years (and relied on the misleading guidance from the **Reserve Bank**), millions of investors will welcome higher interest rates. Conservative retirees intent on protecting capital have reduced their standards of living for years while relying on poor returns from cash and term deposit interest rates. All the signs point to a better future income, at least in nominal if not real terms.

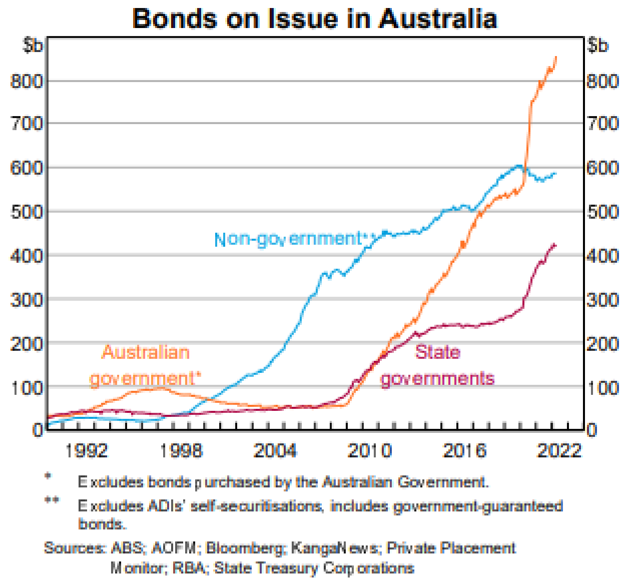
In fact, while the focus is on the cash rate 'soaring' to 0.85% (yes, many of us remember the 17% days back in 1990) and heading to 3% this year, fixed rate markets are well ahead of the game. The five-year bank swap rate is 4.5%, and with spreads on some securities better than 2%, it is not difficult to achieve rates where bond income compares favourably with equities for the first time in years.

Last night (Wednesday), the **US Federal Reserve** raised the Fed Funds rate by 0.75% taking it to 1.75%. It was the biggest increase in almost 30 years, although both equity and bond markets rallied. The Fed indicated that rates will head to 3.4% by year end and to between 3.5% and 4.0% next year to "tighten" the impact on the economy before easing in 2024.

And yet, what will be achieved? We are about to find out how blunt monetary policy is. The Reserve Bank will increase rates to slow domestic demand, in a cumbersome transmission mechanism that feeds into the inability of businesses to pass on higher prices. Many of the inflation forces, such as supply shortages and energy prices, are due to overseas factors. Only one-third of Australian households have mortgages, and the pain inflicted on borrowers will be offset by greater income for savers.

It was not long ago when Modern Monetary Theory (MMT) supporters were explaining that massive government spending had no adverse consequences. Now, we don't hear much about MMT as inflation hits and the Reserve Bank is stunned by the severity of the rising prices. Leading economist **Stephen Koukoulas** is unimpressed by the theory, tweeting this week:

> Stephen Koukoulas @TheKouk · 1h
>
> Isn't it a delight to no longer have MMT stories polluting economic & policy commentary.
> It was entertaining, to a point, to see some fascinating discussions but in the era of high inflation and full employment, its fantasy land ideas have been buried for good.



Did the government and central bank really think we could issue a trillion dollars of debt without any negative consequences? (Source: RBA Chart Pack)

We were warned in these pages. Of all the people who we published in Firstlinks on this subject, it was **Professor Tim Congdon**, Chairman of the Institute of International Monetary Research at the **University of Buckingham** in England who best articulated the inflation consequences of money printing. His first article in April 2020 was called "*Money printing and the reality of inflation*". He warned:

"What is wrong with the supposed 'magic money tree'? The trouble is this. When new money is fabricated 'out of thin air' by money printing or the electronic addition of balance sheet entries, the value of that money is not necessarily given for all time. The laws of economics are just as unforgiving as the laws of physics. If too much money is created, the real value of a unit of money goes down."

That's inflation. Just in case we missed the point, he wrote here again in June 2021, called *"How long will the bad inflation news last?"*. He said about **Jerome Powell**, the US Fed Chair:

"Further, his research staff have evidently failed to explain to him that a monetary explanation of national income and the price level – in which inflation is determined mostly by the excess of money growth over the increase in real output – has a long and distinguished pedigree in macroeconomics."

The inflation genie is out of the bottle. In the US, there was hope that last month's 8.3% was the start of more falls, but the latest at 8.6% shattered that illusion, and bond rates rose and stockmarkets fell in reaction to the highest inflation rate for 40 years.

On Tuesday this week, on the ABC's 7.30, Governor Philip Lowe conceded:

" ... the emergency is over and it's time to remove the emergency settings and move to more normal settings of monetary policy. The other consideration was that inflation is high, it's too high. At the moment, it's 5% and by the end of the year, I expect inflation to get to 7%. That's a very high number and we need to be able to chart a course back to 2 to 3% inflation."

How quickly that will happen, nobody knows, including Lowe. He went on:

"So for most of the past two years, we thought that growth would be slow to recover, that inflation would stay fairly low, that there'd be a long tail from the pandemic and given that, we thought interest rates would need to stay where they were until 2024."

And two other prominent forecasters, fund manager **Chris Joye** and economics editor **John Kehoe**, were also struggling with forecasts last week, expecting a 0.25% rate rise, even when - apparently - Kehoe somehow had the inside knowledge from the Reserve Bank. Joye wrote in the AFR:

"The RBA will hike by 25 basis points tomorrow, according to the Australian Financial Review's economics editor, John Kehoe, bringing the target overnight cash rate to 60bps. Kehoe further asserts that the RBA will continue in 25bps increments until it reaches 110bps in August, following which it will reassess. This all seems like very sensible stuff. It is also the second time in the past few days that Kehoe has delivered what appears to be a message on behalf of Martin Place to actively recalibrate expectations."

Even insider knowledge doesn't help, and there are not many analysts now expecting the Reserve Bank to stop at 1.1%. Chart your own course.

We received this email from the owner of a cafe, saying he needs to increase his prices for the third time this year:

"The cost of food is rising at an unprecedented rate eg: lettuce has gone from $25/Box to $110/Box and it's across the board. As inflation is at 5%, our rent and other outgoings have jumped the most in the past five years. Electricity and gas are poised to go crazy. Albo is going to bump up wages. Super has gone up to 10.5% and we have to pay it on more employees than in the past."

So while we know that the share of national income going to company profits has risen from 21.8% of GDP in the 1990s to 28.1% in March 2022 and lower-paid workers need some respite, remember that measures that seem reasonable on wages and superannuation also hit small business people who themselves are struggling to survive.

Graham Hand

Articles this week ...

The media focus on the cash rate rising to 0.85% with moves higher in coming months overlooks the extent to which fixed rates are so far ahead already, giving investors income opportunities not seen for many years.

At the top of the equity market, investors consistently stop caring whether a company is profitable or not. The fact that this behaviour has changed signals the end of a long bull run. As the US officially enters a bear market, **Daniel Moore** writes about companies expected to regain investor interest.

Steve Johnson has never seen a market this forward-looking and explores the impact of investors' fixation on a looming recession, with a focus on a few companies he sees offering excellent value.

Eric Souders believes rising yields present opportunities across different types of global fixed interest. On an absolute and relative basis, there are compelling reasons to invest in fixed interest instead of equities in the current climate.

For those looking to find the next **Barry Lambert**, the clues are sprinkled in his recollections. **Lawrence Lam's** interview with Barry uncovers the behavioural tendencies that permeated through Count Financial's culture and how sound business decision-making demonstrates the unrelenting heartbeat of a founder.

Manny Pohl writes that by drilling down into a company's financials and growth plans and finding competitieve advantages, it is possible to identify the quality growth stocks that will prosper over the long-term.

On-road vehicles are responsible for the majority of transportation-related greenhouse gas emissions. **Daniel Hanson** believes the transportation sector will play a critical role in achieving the goal of the Paris Climate Change Agreement to keep global temperature rise to well below 2 degrees Celsius above pre-industrial levels.

And finally, congratulations to the Socceroos on their qualification for the 2022 World Cup. As a Foundation Member of **Sydney FC** who rarely misses a home game, I was delighted to see our goalkeeper, **Andrew Redmayne**, become a national hero. 'Redders' has made the Sydney keeper position his own for many years after a shaky start to his career, and he's always been fantastic with the kids at games. Bring on the new season in the new stadium!

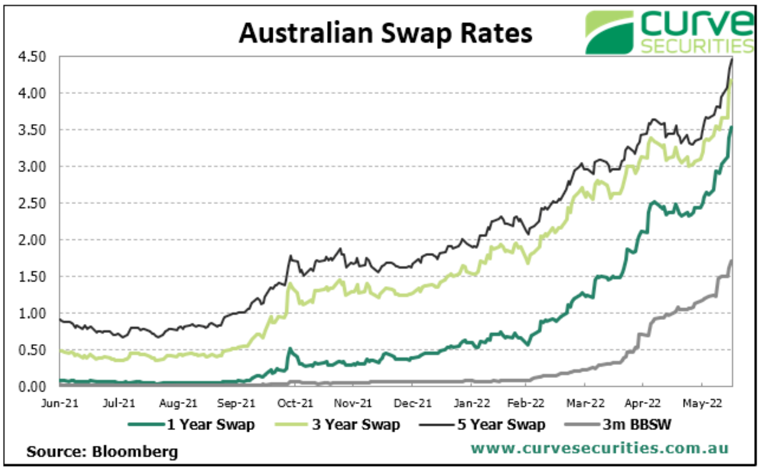
Long-term rates have soared, but is fixed or floating best?

Graham Hand

The threat of higher interest rates, slower economic growth, rising inflation and deteriorating credit is making investing scary at the moment, especially in equity markets. There are few risk-free places to hide, other than short-dated government securities. However, there are income opportunities not seen for many years. With all the focus on the cash rate, many investors do not realise how much long-term bond rates are already far ahead of short-term rates.

The increases in the bank swap rates in recent months have been dramatic, as shown in the chart below. With the five-year around 4.5% and high-grade securities offered at spreads of say 2% to 2.5% above the bank curve, fixed rate investors can achieve up to 6.5% on quality names.

But even for investors willing to place money into bonds to take advantage of better yields, a decision is needed on whether to go fixed or floating.



Some intriguing investment opportunities

Let's clarify some basic terminology.

A fixed rate bond means the coupon or interest rate paid over the life of the bond, say five years, is fixed for the term.

A floating rate bond means the coupon or interest rate varies according to a short-term benchmark, usually the bank bill rate in Australia, even if the term is the same five years. In other words, the rate changes say every three months or 20 times over five years.

(Note that fixed interest rates have been moving significantly every day this week and the rates quoted in this article are illustrating specific points and may be out-of-date within a few days).

A recent transaction by Macquarie Bank shows the fixed versus floating opportunities. Macquarie issued a subordinated bond for $850 million and the market was happy with a credit spread of 2.7%. Investors had the opportunity of taking the 2.7% as a margin over the 3-month bank bill rate or as a margin over the five-year swap rate.

This transaction is known as a 10nc5, that is, the final term could be as long as 10 years with a 'non-call' period of five years. Issuers are expected to call after five years as they lose the favourable treatment as regulatory capital after year five. Macquarie was indifferent to fixed or floating because large borrowers can enter an interest rate swap to convert the fixed rate to floating or floating to fixed according to balance sheet need. Therefore, Macquarie allowed the market to decide the mix.

Based on demand, Macquarie issued $500 million of fixed rate and $350 million of floating rate. What are the investment opportunities?

1. The fixed rate component

Based on the five-year swap rate of 3.35% at the time of pricing and an issue margin of 2.7%, the fixed rate piece offered 6.05% (rates have risen since the deal was priced and it is now available above 6.5%).

For income-starved investors, here is a high-quality bank paying over 6% for five years. Many retirees look to drawdown around 5% from superannuation as an income stream and this has been difficult to achieve for many years without depleting capital.

Two qualifications:

a) the reason rates are rising is high inflation, and so real returns (after inflation) have not increased. However, if inflation falls from 2023 onwards, then 6% to 7% might look good.
b) The debt is subordinated in the credit structure, a notch below Macquarie Bank deposits. It is rated Baa3/BBB/BBB+ (Moody's, S&P, Fitch) which is the bottom rung of the 'investment grade' category, due to its subordination. The pricing was at a 0.1% to 0.2% premium for a new issue and about 0.2% more than CBA subordinated issues which are rated higher (Baa1/BBB+/A-) (Moody's, S&P, Fitch).

2. The floating rate component

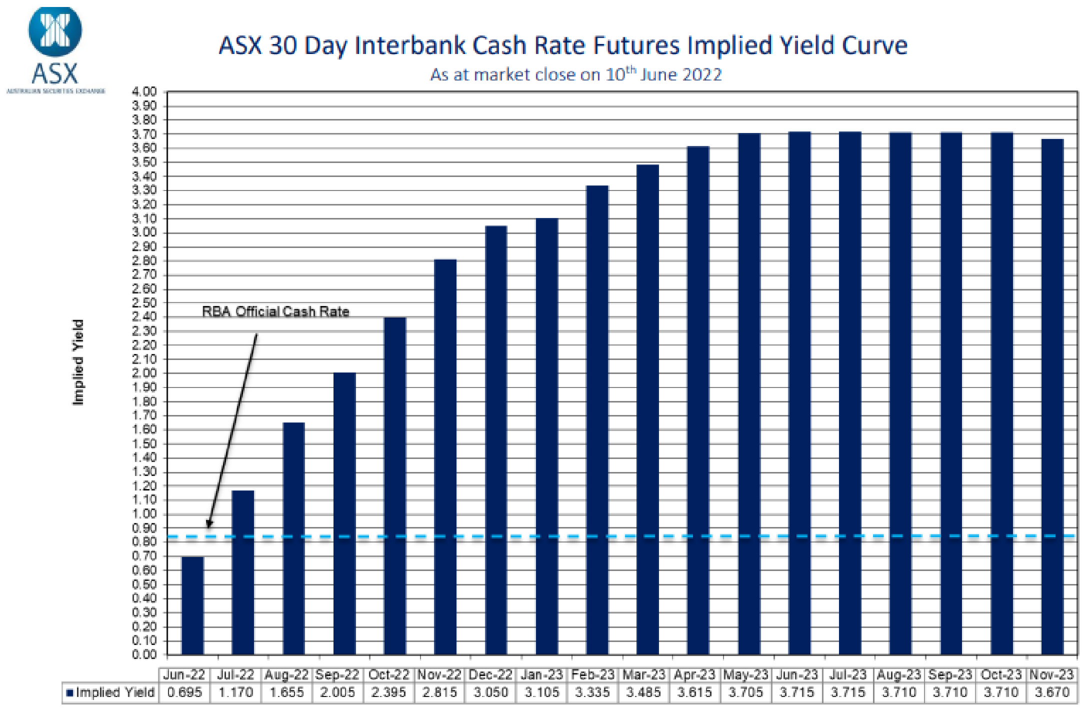
The floater also carries a 2.7% margin. Based on a bank bill rate of say 1.5%, the initial return would be 4.2% (2.7%+1.5%), or significantly less for the first period than on the fixed rate tranche.

The chart below shows the 30-day cash rate futures curve until the end of 2023. At the time of writing, the market is expecting short-term rates to reach 3.7% by May 2023. A rate set with a margin of 2.7% would give a return of 6.4%, which is ahead of the fixed rate tranche.

And therein lies the challenge.

Anyone who thinks the market is pricing rates too high should go fixed and grab the rate on offer now. Anyone who thinks the market is correct or rates will go higher should go floating. (Note this bond is available to wholesale investors only but that is a surprisingly large group of investors, as explained here).

Remember that for fixed rate investors, two risks can send prices down: either term interest rates rise or credit spreads widen, so such an investment should be part of a diversified portfolio.



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For investors who cannot access wholesale bonds, NAB recently issued a new hybrid (ASX:NABPI) paying 3.15% above the 3-month bank bill rate. Again, based on a bank bill rate of 1.5%, the initial yield will be 4.65% buying at par or $100 (prices will vary when trading on the ASX). This hybrid has an expected life of 7.5 years.

But if measured against the 4.5% bank swap curve and 3.15% margin, this hybrid may earn 7.65% in future. The return is similar to the franked yield on NAB's shares without the equity market risk, based on the previous experience that hybrids are significantly less volatile than bank shares at times of market shocks.

Beneath the simple exterior of a floating rate bond, bank hybrids are complicated instruments, including conversion to equity in certain circumstances, but Australian banks are extremely well capitalised.

Retail investors can also consider bond funds, bond ETFs and listed bonds, either in fixed or floating structures, so these opportunities are not restricted to wholesale investors. For a floating exposure, check the fund's fact sheet for a repricing duration of 90 days or less. For fixed rate, the duration is more likely five or more years.

Your fixed versus floating decision

The failure of the Reserve Bank Governor, Philip Lowe, and its Board, to foresee the rampant inflation of 2022 shows that even with the best information in the world, forecasts are a guess. Lowe repeatedly stated until six months ago that cash rates would not increase until 2024, but now the market expects cash rates around 3% by the end of 2022.

Former Reserve Bank Governor Ian Macfarlane recently stated that the inflation target of 2% to 3% will be difficult to achieve and is more likely to stay around 5%.

Adding to the uncertainty, despite US inflation hitting a 40-year high of 8.6% last week, Bloomberg writes that "*Inflation is poised to ease according to these three indicators*". The three items are falling prices of computer chips, shipping containers and fertilisers, all key input to the manufacturing processes of thousands of companies and products.

Either way, nominal yields available to investors now can make a meaningful contribution to the income required to keep up with inflation, and cash and term deposits paying 1-2% have serious yield competition. Fixed or floating, or a bit of each, bonds are back in the game.

A further update from Warren Bird

In 2016, fixed interest expert Warren Bird wrote an article called "Are we going through a bond market route?". Here is a follow up with his thoughts on whether fixed rates are value at current levels.

"Over the last two years, since July 2020, US 10-year yields have risen from 0.55% to 3.43%. That's 2.88% over 23 months. We're seeing negative returns over the two-year period for the typical Australian bond fund of 10-15%. It's not necessarily over yet, of course, so the record bear market move in the US of 3.25% in 1987 is well within reach and could easily be exceeded.

The lunacy of central banks ignoring how their QE had turned into money supply growth in 2020-21, resulting in them not acting to contain inflation a year ago when it was obvious that it was going to be an issue, means that even at 3.4%, the US 10 year Treasury bond is paying a big negative real yield at the moment.

But it's not as negative as cash, so I expect that the big end of town will start to nibble at buying bonds and lengthening duration from here. Cautiously, I suspect, but if the central banks do start acting to reign in their monetary policy accommodation and get us back to a more slow and steady with inflation, then from a longer-term perspective, yields are just about at 'fair value' levels."

Graham Hand is Editor-At-Large for Firstlinks. This article is general information and does not consider the circumstances of any investor. Disclosure: Graham has invested in the fixed rate component of the Macquarie transaction and the floating hybrid of NAB, taking a bit each way in his diversified SMSF portfolio.

Suddenly, the market cares if a company makes money (again)

Daniel Moore

It's amazing to think investors would ever stop caring whether a company was profitable or not, but it seems to happen every cycle, usually towards the latter stages of a long bull run. Companies with a history of reliable profits take a back seat to concept stocks, stocks with no profits but great stories and exciting visions. These stocks are usually early-stage technology companies, industry disruptors or exploratory miners.

Instead of focusing on the usual hard measurements like profit and competitive advantage to pull in investors, they typically market their massive mineral deposits, revenue growth, or the huge size of their TAM (total addressable market). TAM is a particularly spurious measure which in our view often means how much money a company thinks it might be able to make out of a group of people who it thinks might want to buy its product.

Investors get excited by the prospect of high growth and returns and when the market is buoyant it all works. In recent years, particularly, these kinds of stocks looked very appealing with interest rates at all-time lows and bonds returning negative yields. Then, when governments and central banks across the globe poured in trillions of dollars of liquidity during COVID, these unprofitable, high-risk stocks, went stratospheric.

Fund managers and cheer leaders of these concept stocks reached celebrity status (every cycle has them), while fundamental investors like us were left scratching our heads.

At some point while all of this was going on, the market quietly stopped caring whether a company made money or not. It cared about revenue growth, and it cared about the size of the TAM, but companies that made consistent profits were left behind.

Things are changing

Many of the more speculative companies have sold off heavily, and we're seeing other types of companies attract the attention of the market – profitable companies.

A good example is a company we hold in our funds – Amcor. It's a boring company. It doesn't have any celebrity spokespeople, you won't see it splashed across billboards, Elon Musk has probably never heard of it. It makes flexible packaging, as well as rigid containers and other receptacles for food, medicine and other essentials, things people buy in good times and bad. The other thing it makes is money, plenty of money. And not just revenue; Amcor is forecasting a profit of $1.2 billion this financial year.

We were watching the Amcor stock price last week, and suddenly it jumped close to 10%. We double-checked we hadn't missed something. Had it forecast impressive growth? Signed a new deal? Sold off part of its business? No. Amcor had just released its quarterly results and shown, once again, that it was a solid, growing business with sound fundamentals. Yes, it had grown its revenues, as well as increasing its margins (as it was able to pass on higher input costs to its customers).

Source: FactSet; As at 12 May 2022

Nothing particularly different to the last few years, but this time the market noticed, and it acted. The market suddenly realised a global leader in packaging with growing revenues and profits was attractive on 15 times profits (not revenue). As you can see from this newspaper clipping from the '87 crash, this isn't the first time Amcor has performed well in a volatile market.


Amcor chalks up strong first quarter

But Amcor's share price did not remain immune to the crash

Mr Skurrie ... gave optimistic September quarter results, but details were scarce.

Source: Sydney Morning Herald Newspaper, 21 October 1987

Fundamentals again

We are seeing this happen across all our portfolios. Well established, quality businesses that are making a profit and have a competitive advantage, recurring earnings and sound management are performing substantially better than the market.

Here's another example. We also own shares in a company called Aurizon. It's Australia's largest rail-freight company with assets and haulage operations around Australia.

We were at a conference recently and went to an Aurizon presentation. Unlike many other presentations we went to, it was almost deserted. Why? In short, because it's another boring company. A boring company that provides an essential service and makes a good profit out of it.

One aspect that deters some potential investors is that hauling thermal coal is 30% of Aurizon's haulage business. And thermal coal, long-term, is a dying industry. But Aurizon is well-placed to diversify out of coal. It also hauls copper, grain, nickel, iron ore, lithium and other commodities and is aiming to double its bulk haulage business by 2030, while reducing thermal coal to less than 20% of its business. It can also reuse excess thermal coal wagons to haul other commodities, so it doesn't require much capital to diversify.

Another win is that while thermal coal is on the way out, rail itself has a bright future, particularly in goods transport. Once railways are built, they are a very economical, and environmentally sound, way of moving goods around the country.

Finally, all of Aurizon's contracts are backed by CPI, so it's well-placed to pass on any rising costs to its customers, weather the current market volatility and continue to do well. Despite the empty presentation room, it seems the market is starting to agree with us. Aurizon's share price has risen 10% in the last three months. It still trades on a reasonable valuation of 13 times profits and pays a dividend yield close to 6%.

Source: FactSet; As at 12 May 2022

These are just two examples of a shift we're seeing. A shift away from new, "exciting, visionary, ground-breaking companies" to boring, necessary, solid companies. A shift towards well-established, quality businesses, with resilient cash flows, that make good profits and have solid growth prospects.

While these types of companies haven't been catching the market's interest over the past few years, it seems like they are starting to again. It seems like old-fashioned concepts like quality and value, which we've always held on to, are becoming popular again.

We think that high-quality companies are always a good investment. While fads come and go, for us fundamentals never go out of fashion.

Daniel Moore is a portfolio manager for Australian equities fund manager [Investors Mutual Limited](). This material has been prepared for informational purposes only and is not intended to provide and should not be relied on for financial advice.

Is the market's recession conviction warranted?

Steve Johnson

A common refrain is that the market is forward looking. I've never seen it quite this forward looking. Investors are absolutely convinced that Australia is going to have a recession. And that it's going to be a humdinger.

Look no further than Seven West Media (ASX:SWM) for your poster child. Back on 10 February 2022, its share price hit $0.80. As at 14 June, the owner of Channel 7 and The West Australian is trading at $0.38 a share, down more than 50% in four months.

Source: Morningstar

In the interim, it announced an excellent half-year result and, just a month ago, upgraded its expectations for the full year thanks to "strength of advertising markets". It now expects to generate earnings before interest, tax, depreciation and amortisation (EBITDA) of between $335 million and $340 million. That will translate to approximately $180 million of profit after tax for shareholders.

After the share price fall, Seven West's market value is just $740 million, or roughly four times its likely profit for the year.

An advertising recession?

An explanation for such a lowly valuation is not difficult to find. The stock has been downgraded by two well-regarded brokers over the past month, with Morgan Stanley laying out the bear case best:

"Advertising is cyclical, and the economic outlook is softening … we believe it is entirely possible that a 6–12-month period of negative TV advertising growth lies ahead, with the magnitude of the declines more likely to be in the range of -10% to -20%."

Due to its high fixed costs, Seven West's earnings could halve on a 10% decline in revenue.

Is it going to be that bad?

There are three important factors in answering that question.

First, are we about to have a recession? Wide swathes of the market are trading at heavily discounted prices on the assumption that it's coming soon. The ASX Small Industrials Index - a good barometer of the most economically sensitive companies - is now trading below where it was in 2018.

It can't be ruled out. Interest rate rises are clearly going to bite. The Government's stimulus needs to be unwound. But mining and agriculture are important contributors to the Australian economy and conditions have never been better. Other important sectors - tourism and hospitality in particular - are only just beginning their recoveries. There are going to be dramatic shifts in spending patterns, but it's not clear to me that the aggregate translates to a certain decline.

Second, assuming we do enter a technical recession, will it impact advertising budgets the same way previous recessions did?

A jumbled-up economy

When Covid lockdowns first hit back in 2020, Forager's recession playbook was immediately dusted off. Sell everything with high debt burdens. Avoid stocks exposed to discretionary spending - that's the first thing people will cut when faced with the risk of losing their job.

The playbook was useless. Hardly anyone lost their job. Many of those who did, ended up getting paid more by the government than they received when employed. Discretionary consumer stocks like Temple and Webster and Nick Scali made more profits than ever before.

If there is another recession coming, it's going to be another weird one. Some sectors are clearly still humming. In two important sectors for the TV advertising industry - automobiles and tourism - the recovery is only just getting started. Spending levels in those sectors are nowhere near their pre-Covid levels of spending. Harvey Norman will be selling less, but does that mean the total pie needs to shrink?

Third is the assumption that an advertising downturn hits Seven West proportionately. This, I will admit, is likely. As Morgan Stanley points out, this is still a television company. As eyeballs shift online and to streaming services, traditional television is losing market share in the battle for advertising dollars. You won't win analyst of the year for predicting that trend will continue.

But I am having a long-priced wager that the nadir is behind us.

The value in connected television

There is a chance (it is just a chance) that internet-connected TVs change the game for traditional television companies. Traditional media companies' own streaming services are mitigating the loss of eyeballs. That is widely understood. But few are thinking about the value of the eyeballs that remain.

A colleague of mine was watching TV via the 10Play app recently when an advertisement popped up for a new Bunnings at Pymble in Sydney's north. He lives just around the corner, and it is highly likely that the ad was only served to people in that area.

Traditional TV's one big downfall was that it only worked for brands with mass appeal. You had to show the same ad to every single person watching. That's why cars, beer and supermarkets dominate the ad breaks. They still wasted a lot of money on people who don't drive, drink or buy groceries.

The big benefit with connected TVs is that they can serve different ads to different people. Unlike the days of linear television, Channel 7 knows where its streaming viewers live and what programs they like watching. They know their email addresses and, with that, can buy plenty more information about them. Each 30-second advertising slot can then be carved up into different segments and sold to the most relevant advertisers.

We are still in the early stages of this technology's evolution but it is growing fast and, in my opinion, is going to be an incredibly powerful advertising medium. There might be less eyeballs in aggregate, but each could be worth many multiples of its traditional value.

While all of that is specific to Seven West, the expected recession's impact on its share price is not. Retailers like Accent and Adairs are trading at 5-8 times earnings. Small lenders like Plenti and Wisr have suffered share price falls of 45%-70% this calendar year.

I wouldn't bet my life on a recession not happening. But I'm happy to own a few cheap options based on a scenario that isn't as bad as everyone currently thinks.

Steve Johnson is CIO at Forager Funds, a Sydney-based boutique fund manager. 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.

Income opportunities in global bonds

Eric Souders

The first half of 2022 has been a volatile period for most asset classes. Equities are well off their highs, and for the traditional fixed income investor, the spectre of rising interest rates – which correlate negatively with bond prices – is an unwelcome sign.

But things aren't all terrible, and we would argue that there is a possibility the world an avoid recession. Within this outlook, there are still opportunities for the fixed income investor.

Global macroeconomic outlook

Around the developed world, central banks have been adjusting their monetary policy settings in response to increasing inflation.

The combination of COVID-19 stimulus, supply constraints and the invasion of Ukraine by Russia, has led to meaningful increases in inflation. The labour market, particularly in the US, is also very tight, with around two job openings for every person looking for a job.

This has caught the US Federal Reserve (the Fed), and many other central banks including Australia's Reserve Bank, off guard. The resulting central bank policy actions with regard to interest rates are clearly behind the curve. The Fed itself has already acknowledged this:

"There is an obvious need to move expeditiously to return the stance of monetary policy to a more neutral level, and then to move to more restrictive levels if that is what is required to restore price stability."

Markets are now forecasting a number of rate hikes before the end of the year in most developed markets.

However, we believe that inflation may be near its peak, and while it may be a little bit sticky, we are optimistic that central banks acting 'expeditiously' now, will result in inflation moving lower over the next quarter to 12 months.

Growth will slow as interest rates rise but a strong employment backdrop provides good fundamental support and some degree of stickiness for the broad economic outlook.

These are strange times indeed, but COVID-19 was a once in a lifetime experience and its policy ramifications – both good and bad – will take some time for markets to work out. As such, a Wall Street slowdown may not impact Main Street to the degree it might have in prior recessions.

Fixed income opportunities

Given those conditions, let's examine some opportunities for fixed income investors looking for yield in the next 12-18 months.

Government and sovereign bonds will be impacted in the short term by rising interest rates. But that does not rule out all fixed income opportunities, especially those in corporate bonds or credit. As outlined above, the labour market is currently very durable and companies are generally in a good position with regards to profitability and the ability to service debt. The combination of these factors mean the likelihood of broad defaults is quite low.

In this environment you can buy BBB-rated investment grade credit in very solid businesses with yields of around 5%. That is a higher yield than currently available in most equity markets. This has not been the case in the low yield environment for the past two to three years.

There is an opportunity to own solid investment grade corporate debt in companies with sound fundamentals and at yields that are attractive in both an absolute sense and relative to alternative yield options like shares. The price decline in recent months provides an element of price appreciation in-tandem with the aforementioned yield. Investing in short duration fixed income of three- to four-year maturities means less price risk than longer-term bonds.

Looking beyond residential property

Another area we like is commercial property and commercial mortgage-backed securities (CMBS) as they offer a way of incorporating stable income across a targeted set of property types and assets. Commercial mortgage-backed securities can also offer resistance to the inflation backdrop as real property prices will often go up during inflationary periods.

Our investment strategy maintains a favourable view on multi-family, industrial and select office property where fundamentals remain strong despite COVID-19. Commercial real estate debt continues to provide a higher return to that of similarly, or sometimes lower, rated corporates.

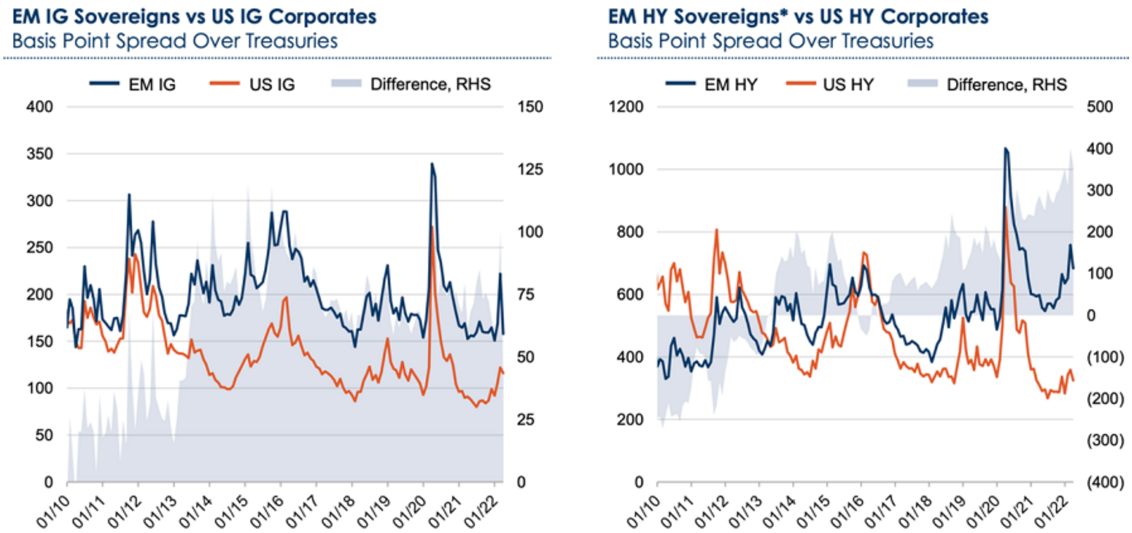
Emerging market sovereign debt

There are some markets where sovereign debt is attractive and emerging markets have been particularly interesting over the past 12 months. The past year has been one of the rare times when central banks in emerging markets have raised rates ahead of the developed world. Typically, you see the reverse, with developed markets like the US, Australia or Europe raising rates first.

However, emerging markets have experienced much more elevated inflation levels in the past year or two, coming out of COVID-19, relative to the developed world and their central banks have been raising rates much faster than the developed world. That now puts them in a position to be able to actually cut rates. And if there is a global slowdown from an economic standpoint, the emerging market world will be able to ease relative to the developed market.

In this kind of environment, emerging market investment grade debt provides relative value and long-term additional spread compensation. As the below charts show, spreads in emerging market high yield debt also show value compared to US alternatives.

Relative value in emerging market sovereign debt



As of Mar 2022
Source: Bloomberg, JP Morgan
**EM HY spreads are ex-Venezuela; the country weight was phased to zero as of Nov 2019*

Bottom line

The economic outlook might look volatile and uncertain but there is still good news for investors with the right attitude.

We believe there are good opportunities in investment grade corporate debt where yields of 5% can be found. We like commercial real estate and are maintaining a preference for securitised debt with an emphasis on collateralised loan obligations and commercial banked mortgage securities given stable fundamentals, relative value, and broad demand for the asset classes.

Eric Souders is portfolio manager of the GFSM Payden Global Income Opportunities Fund. [Payden & Rygel] is a specialist investment manager partner of GSFM Funds Management, a sponsor of Firstlinks. The information in this article is provided for informational purposes only. Any opinions expressed in this material reflect, as at the date of publication, the views of Payden & Rygel and should not be relied upon as the basis of your investment decisions.

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How Barry Lambert beat the banks at their own game

Lawrence Lam

Introduction. Lawrence Lam focusses on companies which are founder-led, due to the passion and expertise of their leader. Here, he interviews a founder who followed his own path in wealth management with great success, and exited the business with perfect timing.

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Barry Lambert founded Count Financial in 1980, self-funding the business and running it whilst juggling a full-time job at CBA. What started as a "*necessity to pay for three kids and a big mortgage*" was sold to CBA for $373 million 31 years later. I interviewed Barry to understand how he built the business from the ground up, without external capital for many years.

Barry's lessons apply not only to business but to life and are an insight into the behavioural differences which make founder-led companies a special hunting ground for investors.

For those looking to find the next Barry, the clues are sprinkled in his recollections. Behavioural tendencies permeated through Count Financial's culture and sound business decision-making demonstrate the unrelenting heartbeat of a founder.

The heart behind a founder's business

After Hours Tax Services. That was the name first given to Count when it was born in 1980. Nothing flashy in the name, more Barry's pragmatism and straight talk. He started working on tax returns as a side hustle. He sought approval from his employer, CBA, noting there was no conflict of interest, since he was working at head office and had no direct contact with customers. He was approved, and the next day he placed an ad in the Yellow Pages.

The response from the ad was strong. As he was busy with his day job and couldn't travel to service all the customers, he started outsourcing the work to other accountants, taking a skim for referral.

As the network and customer base grew, after a few years, Barry's side gig was making him four times the salary of his full-time job, so he quit his banking career after 18 years at CBA. He also felt his own business better reflected the core of Barry's philosophy - *do what's right for the client*. And he didn't see this philosophy at CBA. Incentive frameworks were designed to push clients into low-yielding products called Non-Interest-Bearing Accounts (NIBA) and with high inflation in the 1980s, clients' wealth was being eroded. The promotion of NIBAs didn't sit well with him.

Barry believes the concept of 'doing the right thing by the client' proved a winning formula not only for Count's corporate identity, but because it was a genuine commercial advantage that won market share. Clients listened to technical experts, the accountants, rather than salespeople with vested interests.

Speed of improvement

Barry's matter-of-fact approach to business rubbed off on the way Count was run. If improvements made sense, they would be done quickly without bureaucratic red tape. Count was an early adopter of Australian Financial Services (AFS) Licensing for its financial advisers, to remain ahead of regulations, rather than on the back foot. Some of Count's competitors were outright complacent. Barry recalls how he raised the need for licencing at a lunch with a Big 4 bank and was told, *"Licencing is for people like you; we don't need to be licenced".*

Improvement is a necessity of business, and Count maintained a relatively flat hierarchy. All major decisions went through him, there were no committees and steering groups to contend with. If the strategy made sense, it could be executed much faster than the competition. For example, Count converted into a paperless operation over a few weeks and was an early adopter of emails. They lost seven accounting firms in the transition, but Barry says it was necessary improve the efficiency of the business.

Barry points out the subtle difference between speed of execution versus speed of decision-making. Executing quickly doesn't mean decisions are rushed and ill-considered. Quite the contrary. He often took his time with decisions. *"The solution often doesn't come to you straight away, you usually have to sit on it a bit",* he told me.

There were two main criteria Barry used to make big decisions:

1. solve the problem from first principles rather than copying others, as benchmarking is a flawed concept, and
2. the answer should be simple to manage and not too stressful to implement.

The move into financial advice and wealth management

With this framework, Count morphed from an accounting network into wealth management. In the 1980's, there were no other hybrid accountant/financial planner firms. As with all great ideas, it seems obvious in hindsight. There was no one better placed to provide finance advice than accountants who knew the financial position of their clients intimately.

The solution came because Barry's accountants started receiving requests from wealth advisers who wanted referrals from Count's network. However, Barry felt these financial advisers were more like salespeople motivated by selling investment products, not providing the right advice for clients. Barry believed clients deserve to receive financial advice from professionals and not salespeople. Count applied for a financial advisory licence and started the new service the following year.

Barry created a first mover advantage because Count was independent and relied on accountants providing tailored financial advice. The philosophy and strategy underpinning the business allowed Count Financial to morph into advice using the long-term relationships accountant have with their clients. They understood their financial goals and had the technical background to provide advice.

But back then, most accountants weren't interested in offering investment advice. It involved opening a new business line with more licencing and compliance obligations, something they didn't have appetite to do on their own as single accounting firms. But therein lay the opportunity for someone like Count Financial. They had a network business that had already had scale.

As Barry recalls, he saw the opportunity to transition into an investments business and execute the strategy ahead of others because he was the founder and didn't have the multiple layers of bureaucracy that prevented many others from pursuing bold untested business models.

The idea was to obtain investment licencing and offer training to his accounting network, provide all the know-how and investment knowledge to help facilitate them providing investment advice to their clients. In return, Count would take a percentage of all the investment revenues generated.

Barry had no interest in servicing individual clients but saw a greater opportunity to instead target accountants and to *"leverage their client base"* generated revenues as a percentage of total Funds Under Advice across the network.

Growth was scaled across multiple dimensions, exponential not linear:

1. By the number of accounting firms in the network
2. By the number of clients within each accounting firm
3. By the needs and investment portfolio of each client which would contribute to Count's bottom line.

When I quizzed Barry about how this model was so successful, he attributed it to the 'multiplier effect' - the ability for the business to scale revenues by more than one factor in a differentiated service.

Elevation through differentiation

"One advantage companies that are still run by their founders have over other companies is that founders have the confidence to be unconventional. Employees worry they'll get in trouble if they do things differently. Founders don't." - Paul Graham (Founder of Y Combinator)

Barry told me a made-up word: *'sur-petition'.* It's the name of a book written by Edward De Bono and its concepts stuck with him for decades, and a key ingredient of how he differentiated Count from its competitors. For Barry to compete with the incumbents in their arena would be like driving into a traffic jam. He said, *"The concept of sur-petition is you have to elevate yourself to another level so your competitors don't come looking for you – you're operating on a different plane altogether."*

Barry aimed to add a new service each year. He started with his network of accountants, offering investment licensing and training, then progressively expanding into superannuation, savings, leasing and asset finance. He launched software to aid in the efficiency of his network of accountants. At one point Count had the goal of moving into mortgage broking.

The pace at which new services were being launched was fast. The quicker Count could help its network of accountants entangle their customers, the more entrenched they could become in their financial lives.

A recipe for longevity

The pursuit of growth for any business requires capital expenditure, funded either with internal cashflows or externally through the use of debt or additional equity. Under Barry's leadership, Count always chose internal cashflows, not debt. Barry recalled in the late 1980s, he took out a $200,000 working capital facility and discovered the interest rate was 20.5% (in those days interest rates weren't shown on statements so he had to call the bank to discover that surprise). Barry paid off the loan and decided he would never take out another loan for the business again.

And Count never had to. It was profitable and able to use internal cashflows to fund its growth strategies. Unlike his competitors, Barry had a conservative approach to expenses. Competitors would come and go, often bursting onto the scene with big marketing budgets that eventually fizzled out. Barry tells me there was one competitor backed by a large corporate who muscled in with a $2 million marketing budget over 1-2 years. They didn't last in the end.

A debt-free capital structure makes sense in some environments, but not necessarily in others. Count could use its strong financial foundation as a weapon to outlast its competitors. The strategy proved effective in the financial services environment at the time.

And the rest is history. In a piece of exquisite timing in 2011, Barry sold Count Financial to CBA for $373 million, before the onset of the Future of Financial Advice (FoFA) regulations which permanently changed the incentive structure of the industry. Banks exited wealth management as the vertically-integrated models no longer worked, and CBA sold Count Financial in 2019 for $2.5 million.

Lawrence Lam is Managing Director and Founder of Lumenary Investment Management, a firm that specialises in founder-led companies globally. For more articles and information, visit https://lumenaryinvest.com. The material in this article is general information only and does not consider any individual's investment objectives.

Two companies with clear competitive advantages

Dr. Manny Pohl

After the turmoil of recent years, many had hoped that 2022 would see a return to a more normal environment. However, the year has been punctuated by macro events such as the crisis in Ukraine, and the Fed's tightening cycle in the US is impacting equity markets globally.

As this uncertainty continues, it is more important than ever that investors have a sound investment process. It is vital not to get caught up in the hype and noise of the daily market movements, and instead invest with a long-term approach. To help with this, it may be useful to have some guidelines to fall back on when the market noise gets too loud.

Companies that have a sustainable competitive advantage will be better placed to withstand short-term headwinds, maintain market share, and ultimately find new ways to grow.

It can however be difficult to recognise this potential in companies, particularly those that are in the growth stage of their life cycle. And while challenging, it is also important to balance both the narrative and the numbers.

By drilling down into a company's financials and growth plans, it is possible to identify the quality growth stocks that will prosper over the long-term. The best way to explain how this process works is through a couple of examples.

CSL's M&A activity

CSL is a multinational biotechnology company that operates in both plasma and influenza markets. It was founded in 1916 and listed on the ASX in 1994.

Throughout its history, it has been able to create a competitive advantage in the areas it operates in through acquisition and combining product portfolios, manufacturing, and distribution to boost the value of the acquired companies.

It has a good historical track record of efficiently deploying capital in attractive growth areas. For example, its acquisition of Aventis Behring, the second largest plasma player, in 2004 has proved to be transformative over the past 18 years. This acquisition enabled CSL to more than double the products produced per litre of plasma from two to five, as it added haemophilia and speciality products. This is now a key source of CSL's competitive advantage in this area.

For an acquisition cost of $US925 million in 2004, the Behring division now generates US$8.5 billion in sales and US$3.1 billion in earnings before interest, taxes, depreciation, and amortisation (EBITDA).

CSL clearly has what we call a Dynamic Capability - a change-oriented capability that helps a firm redeploy and reconfigure their resource base to meet evolving customer demands and competitor strategies.

CSL has recently entered the renal and iron deficiency market with the acquisition of Vifor Pharma. The market is focussing on the delayed recovery in plasma collections, donation inflation and a US$5 billion capital raising, and has sold down CSL accordingly. However, we believe that CSL will be able to apply the earlier lessons learned via its acquisitions in the plasma and influenza markets to the Vifor acquisition and potentially dominate the renal market as well.

Source: Morningstar

Lovisa's growth path

[Lovisa Holdings](#) is a fast fashion vertically integrated affordable fashion jewellery retailer. It aspires to be a global player and already has more than 70% of its stores operating overseas.

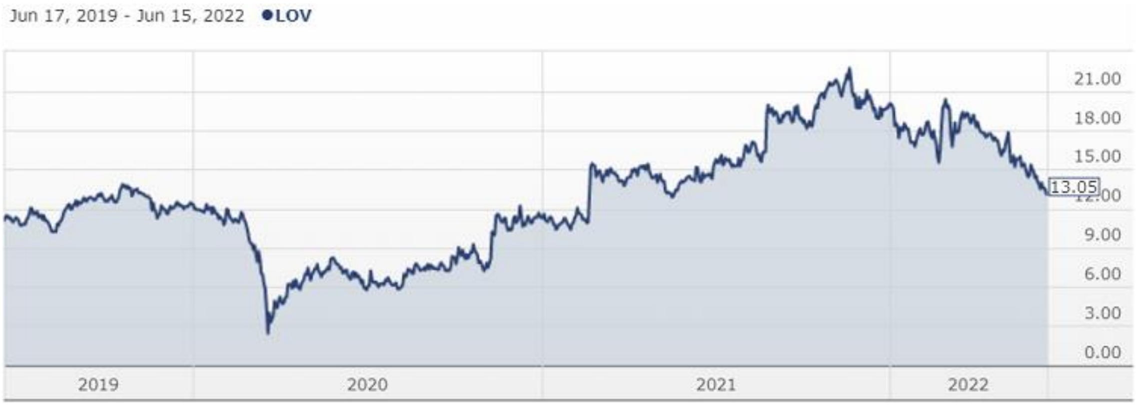
A combination of a clear specialisation in affordable jewellery, vertical integration which enables frequent inventory turnover and speed to market, and negotiating leverage due to scale and capable leadership, makes for a competitive business model.

In addition, Lovisa has a clear top-down focus on data. Stock placement is based on a design created by head office each week, using the prior week's sales data. This universal approach to product placement generates maximum sales from Lovisa's wall space.

Because of this focussed approach, Lovisa also has a short payback period for domestic stores of approximately eight months, with new store fitouts taking only 14 days on average.

While Lovisa's founding CEO Shane Fallscheer retired last year, Inditex Group veteran Victor Herrero became CEO in December. Herrero's experience managing global expansion at Inditex Group, which owns Zara, Pull & Bear and Massimo Dutti, will be advantageous to Lovisa's global growth plans.

Lovisa's proven and astute business strategy, combined with superior management, make it a Quality Franchise that presents a long-term opportunity for investors.



Source: Morningstar

Common ground

While CSL and Lovisa seem, at face value, to be very different companies, they have key characteristics in common. Both have the ability to assess market needs quickly and adjust their offering rapidly to meet changing demand or requirements. They have also successfully expanded into global markets with little impact on the effective management of the business.

The ability to be flexible, to move quickly to take advantage of opportunities as they arise, and capitalise on market trends and demand, will continue to support the ongoing success of such businesses, and provide significant long-term opportunities for their investors.

Dr Manny Pohl is Founder and Chairman of ECP Asset Management. This material has been prepared for informational purposes only and is not intended to provide and should not be relied on for financial advice.

Electrification: Paving the road to emissions reduction

Daniel Hanson

As investors focused on long-term sustainability, we have long focused on emissions, energy efficiency as well as long-term opportunities and threats in business models as it relates to their sustainability and competitiveness over the long run. This includes evaluating these considerations from an operations perspective, but also from a products and services perspective. Greening of transportation, greening of real estate infrastructure, greening of industrial tools and equipment—these are some examples of product life cycle innovation, on the road to drastically reduced emissions in the long term. In this piece, we focus on the potential opportunities relating to electric vehicles.

On-road vehicles are responsible for the majority of transportation-related greenhouse gas emissions. In particular, emissions from light-duty vehicles, which include passenger cars and light-duty trucks, accounted for 61% of total sector combustion emissions in 2016. Emissions from medium- and heavy-duty vehicles accounted for 23% of total sector combustion emissions while combustion emissions from all other transport modes together made up the remaining 16% of total transportation sector combustion emissions.

Electric Vehicles (EVs) are two to four times more efficient than conventional internal combustion engine models, which can reduce reliance on fossil fuels and can enable significant reductions in greenhouse gas emissions (GHGs) as well as air pollutants [*IEA Global EV Outlook 2021*].

By emitting no tailpipe emissions, EVs have the potential to significantly decarbonize the U.S. transportation sector. The question remains, however, how long will this take? While EVs of all types are already displacing over 1 million barrels of oil demand per day, the U.S. transportation sector currently remains far from zero emissions, as the composition of the current on-road vehicle fleet is mostly gasoline vehicles and the impact on overall GHG emissions is limited in the near term. EVs represent a growing yet small share of all vehicles on the road today while internal combustion engines will remain on the road for at least another decade or longer before being completely phased out. According to Bloomberg New Energy Finance (BNEF), as soon as 2030, nearly 60% of new car sales must be zero emissions, to stay on track for BNEF's Net Zero Scenario.

EV commitments from governments and the private sector are necessary for the world's net-zero goals to be met in the transportation sector. So far, gradual tightening of fuel economy and tailpipe CO2 standards, in the EU in particular, has augmented the role of EVs to meet the standards. Today, over 85% of car sales worldwide are subject to such standards. To date, more than 20 countries have announced the full phase-out of internal combustion engine (ICE) car sales over the next 10 to 30 years, including the U.K., China and several European countries. [*IPCC, 2018*] In response, the world's major automakers have stepped forward with their own commitments to phase out internal combustion engine vehicles over the next decade.

Automaker Commitments

- GM will invest $35 billion globally in EV and AVs through 2025. GM also plans to be carbon-neutral? by 2040 in its global products and operations.
- Ford is investing $22 billion through 2025 to deliver battery EVs, and plans to be carbon-neutral by 2050.
- Honda will sell only EVs and hybrids in Europe after 2022. By 2030, Honda says 40% of its North American vehicle sales will be either battery electric or hydrogen, and by 2040 all gas cars will be phased out.
- Toyota will have 70 electrified models by 2025, 15 of them battery EVs and seven of them with the Beyond Zero bZ brand. Pickups will also get electrified, and Toyota has the goal of being carbon-neutral by 2050.

- Volkswagen says that battery EVs will be 70% of its sales in Europe in 2030, up from a projected 35%. For the U.S. and China, the VW brand goal is more than 50% full-electric vehicle sales by 2030. The VW Group has 70 new electrified models in the pipeline, and several already on the market.

EVs Are on the Cusp of Rapid Expansion

Over the past decade, we have seen sales of EVs go from a trickle to a steady stream of rapid adoption. While EV penetration necessary to reach net zero by 2050 is a long way off, there seem to be signs that 2020 was a pivotal year for EVs, which are now on the cusp of rapid expansion and have momentum to move the transport sector towards a path to decarbonization. We believe the transportation sector will play a critical role in achieving the goal of the Paris Climate Change Agreement to keep global temperature rise to well below 2 degrees Celsius above pre-industrial levels.

Over 1 billion passenger cars travel the streets and roads of the world today, and by 2040, that number is set to double to at least 2 billion. There were 10 million electric cars on the world's roads at the end of 2020, following a decade of rapid growth. Vehicle manufacturers have since announced increasingly ambitious electrification plans. Out of the world's top 20 vehicle manufacturers, which represented around 90% of new car registrations in 2020, 18 have stated plans to widen their portfolio of models and to rapidly scale up the production of light-duty electric vehicles. The model availability of electric heavy-duty vehicles is also broadening, with four major truck manufacturers indicating an electric future.

As EVs continue to drive advances in battery technology, batteries keep getting better and more cost competitive. Average battery energy density is rising at 7% per year and new chemistries are hitting the market faster than ever. Maximum EV charging speeds are also rising. Lithium-ion battery pack prices fell 89% from 2010 to 2020, with the volume-weighted average hitting $137/kWh. Many expect underlying material prices will play a larger role in the future, but the introduction of new chemistries, new manufacturing techniques and simplified pack designs will keep prices falling.

Technology Solutions Enabling the Path to Electrification

Despite all the progress to date, much remains to happen in order to hit the 2050 Paris Climate Agreement goals, according to a report by the World Resources Institute.

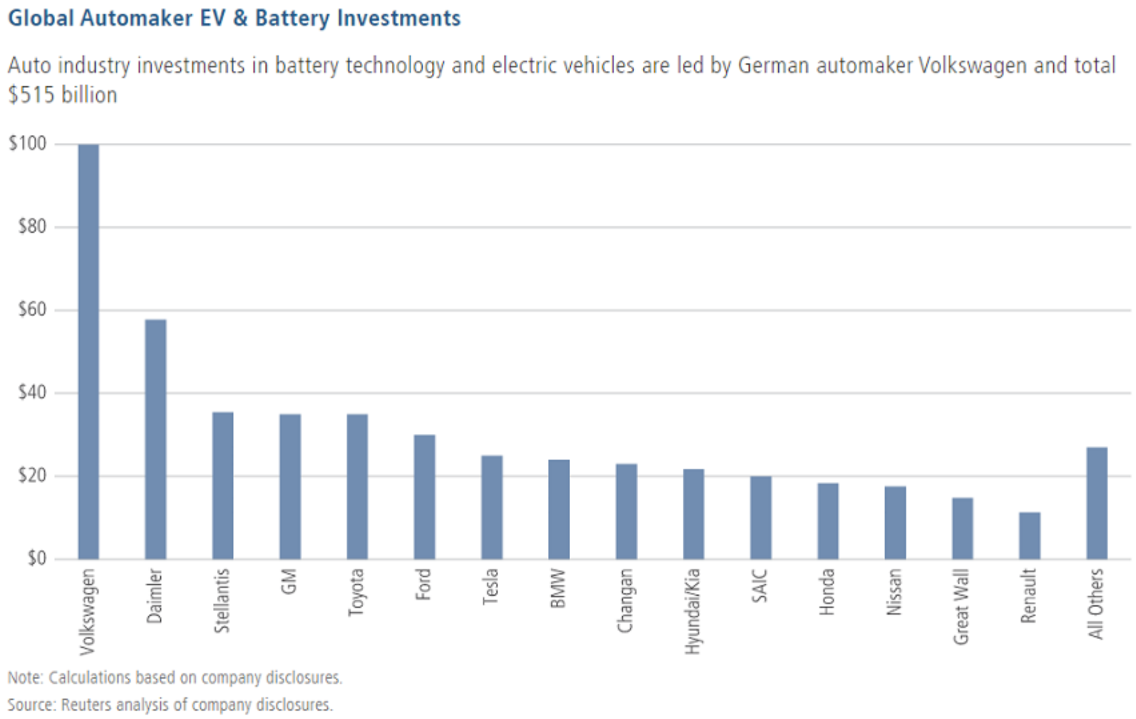
According to the report, an aggressive multifaceted approach is needed to accelerate the progress. We can't look to just one piece of the industry to solve the problem; for example, we need the grid/charging infrastructure for the renewable energy supply to power the EVs; we need more semiconductors; we need solutions for greening commercial trucks and transport. And while these technologies can improve the CO_2 profile of vehicles on the road, there is potential for technologies like autonomous ridesharing to pull tens of millions of vehicles off the road altogether. The report indicates that all of these things in tandem will have a multiplier effect on achieving meaningful goals to expand electrification. We discuss the progress with a few of these solutions below:

Semiconductors

EVs require both more semiconductor content and more advanced chips than gasoline-powered vehicles. Semiconductors enable EVs to be efficient, safe and interactive, and are necessary for a car's battery, powertrain and firmware. We believe the demand for semiconductors will only continue to grow and enable the expansion of EVs. Current supply chain shortages can largely be traced back to production cutbacks due to the COVID-19 pandemic.

Auto Parts/Auto Makers

Automakers are now enabling EVs to go mainstream. Every international automaker is introducing battery cars, and plug-in hybrid options are increasingly part of model lines. Global automakers are planning to spend more than half a trillion dollars on electric vehicles and batteries through 2030, according to a Reuters analysis, increasing investments aimed at meeting increasingly tough decarbonization targets. The most recent analysis shows carmakers planning to spend an estimated $515 billion over the next five to 10 years to develop and build new battery-powered vehicles and shift away from combustion engines.



Grid and Charging Station/Infrastructure

As the country adds more EVs to the road, charging infrastructure will be needed to support them. According to Department of Energy data, as of 2021 the U.S. has fewer than 46,000 EV public charging sites compared to more than 150,000 gasoline fueling stations.

President Joe Biden's $1 trillion infrastructure package, which was recently passed by Congress, includes $7.5 billion toward a nationwide network of 500,000 EV charging stations by 2030. We believe this is likely to fall short of what is needed but is seen as a much-needed boost for meeting the most immediate infrastructure needs.

Daniel Hanson is the Senior Portfolio Manager and Head of the U.S. Sustainable Equity team at Neuberger Berman, a sponsor of Firstlinks. This material is provided for informational purposes only. Nothing herein constitutes investment, legal, accounting or tax advice, or a recommendation to buy, sell or hold a security.

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