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Editorial

All investors use a logic and an intuition to guide which investments are most suitable, and investors develop and modify decision-making as their knowledge grows. Along the way, they meet people with different views, sometimes so confidently and expertly expressed that they may influence a change in beliefs. Investing is as much art as science and there are few absolutes, especially in the market conditions we currently face.

In my 45-year career, I have attended thousands of meetings, including with both the smartest and the most inept characters ever to carry a business card. When I was responsible for global funding at **Commonwealth Bank** and **State Bank of NSW**, we hosted domestic and overseas bankers every day, and each visitor came with a banter, an opinion and something to sell. The vast majority of encounters are buried in the back of what's left of my hippocampus, never to be retrieved.

But some meetings stay prominently in the memory, and one in about 1990 or 1991 included a lesson I will never forget. Short-term interest rates were around 16% to 18%, as shown below, and five-year rates were heading down from 15%. It was the time of the "*recession we had to have*" and inflation was rife and an accepted part of the investment landscape. Nobody thought 'normal' for interest rates would ever approach 2% or 3%.

Reserve Bank of Australia Cash Rates 1990 to 2022

At this time, the leading house in Australian fixed interest and bonds was **Dominguez Barry Samuel Montagu, or DBSM**. In May 1991, a majority stake was acquired by **Swiss Bank Corporation** which made its position even stronger. One day, a senior executive from DBSM presented to us an idea for a major transaction, which went something like:

"We've seen the five-year swap rate at 15% and it's heading down, but in my experience, whenever it hits 12%, it always bounces up off this level. We should arrange a major fixed rate issue for you at 12% and you leave it fixed, ready to lend at higher rates after the bounce."

Our risk management processes were sophisticated and we did not appreciate an investment banker telling us how to take advantage of rising rates as a way of generating a bond placement fee. But what stuck in my mind was his confidence based on his vast experience. He was absolutely sure rates would bounce off 12%. We ignored his advice and never did the transaction, and the deal would have been very expensive, as rates fell well beyond his magic 12% barrier.

And so to today. Prior to the last six months, it was commonly accepted that inflation and interest rates were very low and built into the economic system. Central banks were struggling to push inflation into a preferred 2% to 3% band. Tech innovation and improving global logistics were driving down prices. Then in FY22, for the first time in 30 years, in the face of a central bank switch to control inflation, all asset categories in a diversified fund (except cash) fell significantly in price.

For a range of reasons - the Ukrainian war, the Chinese threat, declining global trade, food and energy inflation, demographic challenges - it feels like a reset of our expectations.

Former Leader of the Opposition, noted economist and university professor, **John Hewson** wrote in **The Saturday Paper**:

*"I have been analysing and forecasting economies since joining the International Monetary Fund in the late 1960s, and I can say it is **much more difficult now than at any time since then** to predict how the world and our economy will evolve. Multiple global liquidity injections, stretching back to the Alan Greenspan era of the early 2000s through to the responses to the 2008 global financial crisis, and most recently to the pandemic, have finally released the inflation genie. As a result, major central banks are reversing their easy monetary policy settings and rapidly raising interest rates." (my bolding)*

Investors need to consider if we are in a new paradigm. What if interest rates rise to 5% or more? Are the days of inflation below 2% over? Has global population peaked, with implications for economic growth? Do the tools we use to manage the economy work as we expect? As US author and geopolitical analyst **Peter Zeihan** says in his most recent video:

*"**The relationships between all of the tools that we use to regulate the economy might not apply anymore.** For the bulk of modern human history, the last 500 years, it's all about figuring out how you can maximise your share of a pie that is steadily growing. We've had steadily growing population growth turning into explosive population growth in the industrial era that postdates World War Two. And as long as there are more people, as long as there is more technology, growth is easy. And regulating inflation and growth and employment all the rest of that environment is something we have a lot of experience in. But that's not the case anymore. The global population is in the process of peaking. The advanced world population has long since peaked ... if the pie is no longer getting bigger, then it's not clear that any of our measures, whether it's for inflation, or growth or investment, or otherwise, are even relevant anymore, much less tools like interest rates ... **They (policymakers) are literally making this up as we go along."** (my bolding).*

The **Reserve Bank** is making its decisions month-by-month "*guided by the incoming data*" having learned the lesson not to predict years ahead. The different views of the major bank economists shows how difficult predicting the next step has become. While **Westpac** and **ANZ** see the cash rate peaking at 3.35% this year, **CBA** and **NAB** are at 2.5%. That's a difference of more than three 0.25% increases in the space of a few months, and 3.35% is a long way from the current 1.85%.

Another lesson from the 1980s and 1990s is that central banks struggled to control inflation and went hard on rates to reduce demand. The Reserve Bank may overreact on the upside in the same way it overreacted on the downside for too long in 2021.

Regardless of what we think will happen, we should not to be as dogmatic as my friend in 1990. Rates bounce off 12%, right? There are few certainties in investing and companies are coping with profound changes. There is a strong case that returns will be subdued for a while. Global geopolitical problems are not going away soon.

Complicating the investment decision is that stockmarkets often recover when conditions are at their worst. Even if interest rates and economic growth are known with 100% certainty, the market reaction remains a mystery. The NASDAQ is now up 20% from its June 2022 lows, despite the same recession and inflation threats that pushed it down over the previous six months.

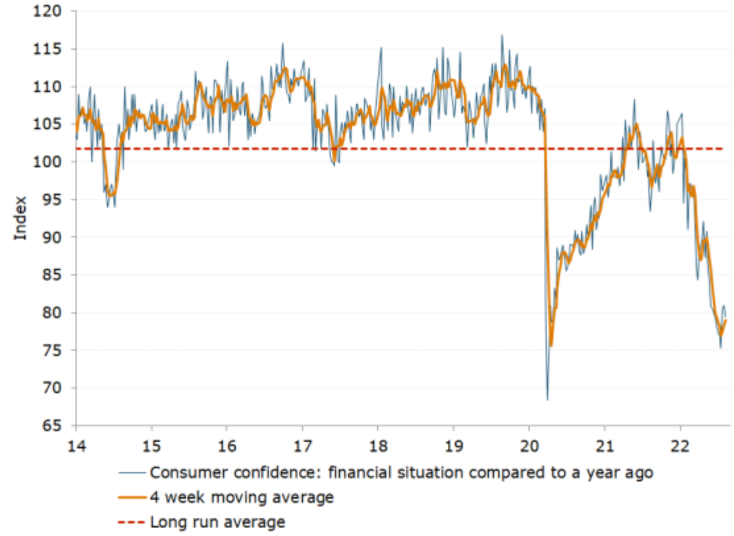
In this context, the article by **Julian McCormack** is timely as he discusses the [paradox of investing](). When investors are lulled into confidence and certainty, as in 2021 coming out of the pandemic, that's when a new cycle kicks in:

"It is investors' certainty that they are in unprecedented times, armed with better information than ever and standing on the cusp of hitherto unseen technological wonders, which leads them into the paradox of cycles. It is only when investors are certain they are not in a cycle, that truly wild cycles can emerge."

The Reserve Bank wants to talk down inflation and economic activity while engineering a soft landing, and although only one-third of Australians have a mortgage, the threat of falling house prices and rising mortgage repayments is already playing into consumer confidence. As **Alex Joiner**, the **IFM Economist** says:

"When weighing up the business and consumer sentiment outcomes today, it's notable that households account for around 53% of the real economy via spending. So while business sentiment likely means people keep their jobs, if they also stop spending, growth will unravel."

Figure 3. 'Current financial conditions' softened 1.9%



Source: ANZ-Roy Morgan

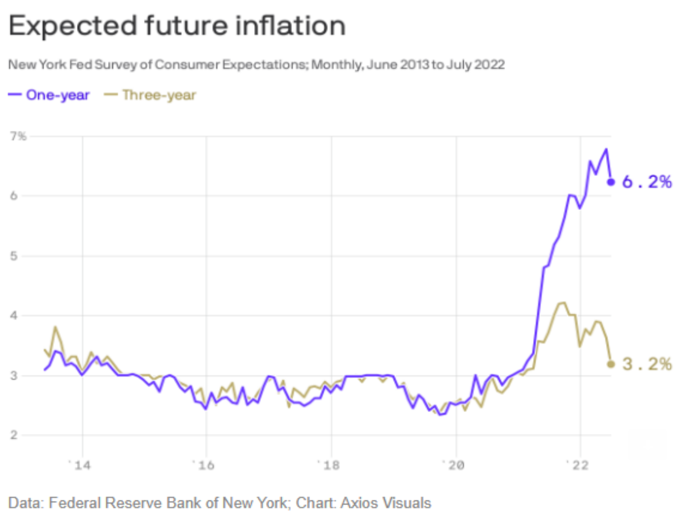
What about in the US? On Wednesday night our time, the year-on-year CPI was down to 8.5% from 9.1%, as shown below. The market jumped on the optimism that inflation may have peaked, with falls of 8% in petrol and a 11% in household gas prices (shaded areas are recessions).

US CPI, 12-month percentage change, all items

Source: US Bureau of Labor Statistics

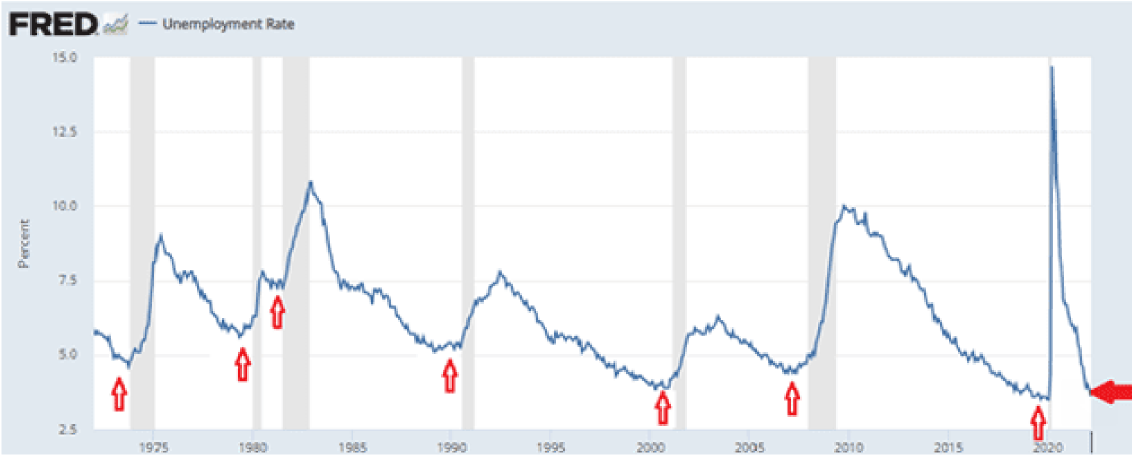
In addition, respondents to the **Federal Reserve Bank of New York** survey in July expect inflation to grow at a 6.2% pace over the next year, down from 6.8% in June, while the three-year number is 3.2%, down from 3.6% predicted in June. The main driver is the easing of fuel prices and food categories. According to **David Kelly,** Chief Global Strategist at **JPMorgan:**

"Overall, with demand slowing and supply picking up, we expect to see steady downward pressure on inflation for the rest of this year and in 2023 even if the Federal Reserve pursues a slightly less hawkish path."



Meanwhile, **John Mauldin**, another US commentator, included a revealing chart in his newsletter this week.

The shaded areas are US recessions, mapped against the US unemployment rate. It suggests unemployment bottoms just before a recession, as jobs growth comes from an overheated economy which drives up inflation.



Source: Richard Vesel

In this week's edition ...

While we don't usually focus on company earning results, this current August Reporting Season is shaping up as one of the more important. **Reece Birtles** says it will show which companies and sectors are managing to control costs and pass on price increases, and there are likely to be extremes, as US results have showed recently. Then **Rudi Filapek-Vandyck** looks at some results which have already issued for resources, property trusts and asset managers for early signs that there will be winners among the strugglers.

Remember when **Macquarie Bank** and its various complex structures were the successful bidders for **Sydney Airport** back in 2022? It was all over the news, and even **Alan Jones** on **Radio 2GB** laughed at the ridiculous $5.6 billion paid, way more than the underbidders. Of course, Macquarie had the last laugh as they forced us to walk through duty free to reach the departure gates, raised parking fees because we had nowhere else to go, and built hotels and retail space. **Stuart Cartledge** was an investor for 20 years until the March 2022 sale for $32 billion, and it's fascinating to read an insider view in a case study transaction.

Ethical and sustainable and ESG funds have faced challenges in calendar 2022 as global oil and commodity shortages led to a surge in energy and resource companies often not held in these types of funds. **Angus Dennis** explains how the managers have approached this period, he shows how his ethical fund differs from the index, and why the fund's stance pays off over time.

Then **Brian Feroldi**, a US author and investor, gives a snapshot of 10 common mistakes that new investors make. Perhaps everyone should go through a stage of learning these lessons while there's not much capital at risk. Feroldi admits he made each of the mistakes in his early days, and he gives US stock examples.

To many investors, RMBS, or Residential Mortgage Backed Securities, may seem arcane, but they are issued by the billion each year in Australia to finance housing loans. While wholesale investors may be able to access directly from a broker, retail can invest via a managed fund, ETF or Listed Investment Company. **Ashley Burtenshaw** explains how they work and why no Australian investor has lost money on a domestic RMBS to date.

This week's White Paper from **Epoch Investment Partners**, affiliated in Australia with our sponsor, **GSFM**, asks a somewhat satirical question about selfish companies denying consumers cheap products. But earning good returns on capital is not an obstacle to satisfying consumer demands. It is what enables companies to continue to invest to meet those demands.

A footnote to our article last week arguing the Reserve Bank's reliance on quarterly CPI data was unacceptable. The **Australian Bureau of Statistics** announced that from 1 October 2022, it will provide monthly CPI data, accepting that policy settings need more up-to-date information.

Graham Hand

The paradox of investment cycles

Julian McCormack

Central to the perpetuation of stock market cycles are emotions: excitement, hope, avarice, perhaps some envy. These are ever-present in our makeup, so they alone cannot explain market cycles. Something needs to catalyse humans to act as a herd in markets. That something is certainty.

It is investors' certainty that they are in unprecedented times, armed with better information than ever and standing on the cusp of hitherto unseen technological wonders, which leads them into the paradox of cycles.

It is only when investors are certain they are not in a cycle, that truly wild cycles can emerge.

We are witnessing the turning of one of the great cycles of market history at present, with stretched valuations and enormous market capitalisations imploding. At the same time, the ebbing tide of fiscal stimulus likely precipitates significant earnings falls for US companies. Remember though, it was only one year ago, in mid-2021, that investors were certain of the supremacy of US companies, of the benign nature of inflation and the remoteness of the possibility of cycle-killing monetary policy adjustments.

How recently we were enthralled

I spoke at an investor forum for retail investors in mid-2021, where I was one of a panel of three speakers. The other two speakers spoke of wonderful technological disruptors, US listed, trading near their all-time share price highs. When prompted, they dismissed the likelihood of any serious inflationary cycle and denigrated concerns about valuation. The future was obviously bright for these tech titans.

I chose to make a point by speaking about the absolute opposite of such tech wizards – a Chinese property developer. Since the forum, the obvious has happened. The lauded tech firms are down roughly 80%, while China Resources Land – a holding in our Asian and global funds – is up 15% and has paid us 4% in dividends.

It is the certainty of investors that upstart tech firms are the future that allows them to bid the share prices to ridiculous levels. And it is the doubt and perplexity surrounding a name like China Resources Land that allows its price to appreciate even amid a property slowdown in China and implosion of equity markets globally.

It was ever thus: the 1970 'tech wreck'

It is useful to refer to past cycles rather than simply assert that current events constitute a cycle that is ending badly. Helpfully, case studies from the past illustrate points that are obvious to readers decades after the events described. Unhelpfully, it is difficult to empathise with people paying high prices for the darlings of prior cycles … *of course*, they were silly to do so. We must try to remember that the excitement of prior cycles was not felt in black and white. It was as real and as vivid as any contemporary lust for profit.

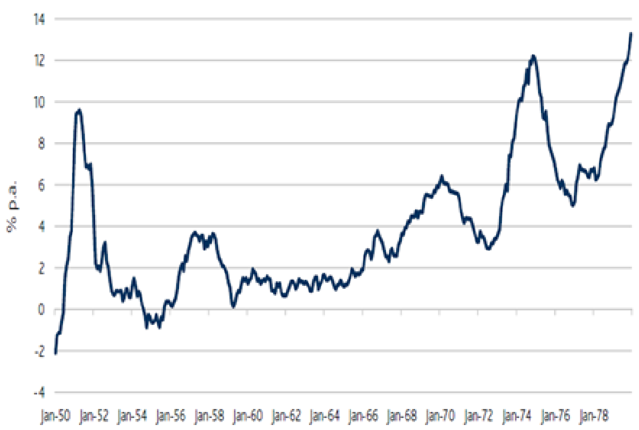
In the 1960s, a series of emerging tech giants, IBM and EDS chief among them, had enormous growth runways ahead as they embarked on digitising all corporate and government information in existence. Every pay cheque, every Medicare bill, and every management memo would soon be recorded on a computer. What a story!

The 1960s saw a series of certainties entrench themselves. There was mild inflation in the system, and interest rates were low. Indeed, no investor had seen short-term rates above 4% since 1929, nor had inflation risen above 4% apart from brief spikes in the late 1940s. Amid benign inflation, low rates for decades and a staggering growth story, a colossal growth stock bubble duly emerged.

IBM was the era's tech behemoth, but it had competition. In 1962, a star computer salesman at IBM, a young Texan by the name of Ross Perot, became fed up with a lack of advancement within the IBM machine and set out with a couple of colleagues to found a computing upstart with only US$1,000 in capital: Electronic Data Systems, or EDS. Times were lean for EDS in its early years until federal Medicare legislation was passed in 1965, and EDS won a contract to develop a computerised system for paying Medicare bills. EDS soon had contracts in 11 states and by 1968 had US$10 million in assets generating US$1.5 million in profits and a stupendous growth trajectory. The time was ripe for an initial public offering (IPO) for EDS, and a largely unknown Karl Langone won the deal by promising a valuation of over 100 times 1968 earnings. EDS listed at US$16.50 per share, at a price-earnings multiple of 118 times. This was just the start. By early 1970, EDS went on to trade at nearly 10 times its offer price, at US$160 per share.[2]

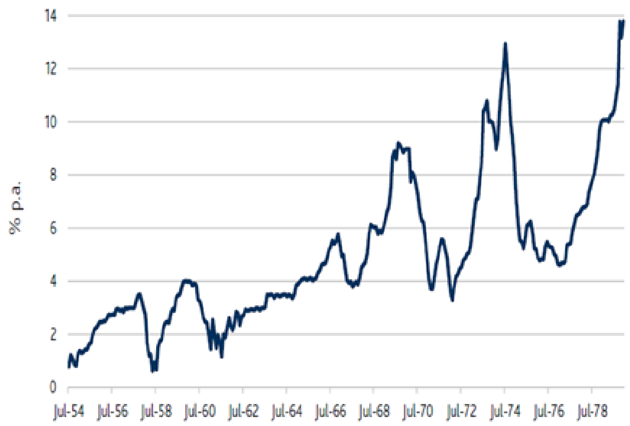
However, the certainties of the 1960s had eroded. Inflation surged over the course of the decade, which prompted a response from the US Federal Reserve, driving up short-term rates from 1967 to early 1970 from 4% to 6% in the Fed Funds market, before racing higher to 9% in mid-1970. Despite robust earnings growth in many cases, computer [share prices were crushed](). EDS fell from a peak of US$162 to US$24 per share in May 1970. The average computer stock of the day fell 80%.

Fig. 1: US CPI, 1950-1979



Source: Federal Reserve Bank of St. Louis.

Fig. 2: Fed Funds Rate, 1954-1979



Source: Federal Reserve Bank of St. Louis.

How can this happen, repeatedly?

Again, we would point to certainty. Investors abandon scepticism. They *know* that inflation will remain benign, or will be transitory, or will be permitted by monetary officials. They *know* that fast growth deserves a colossal multiple, or that multiples don't matter, or that a multiple of sales is appropriate to "value" a stock.

This certainty is seductive … and fatal for returns for those who believe unto the end.

[1] Source: FactSet Research Systems, in local currency, annual return to 30 June 2022.
[2] See John Brooks, *The Go-Go Years; The Drama and Crashing Finale of Wall Street's Bullish 60s*, Allworth Press, 1973, pp14-24

Julian McCormack is an Investment Specialist (Retail) at [Platinum Asset Management](), a sponsor of Firstlinks. [View Disclaimer]().

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Reporting Season will show cost control and pricing power

Reece Birtles

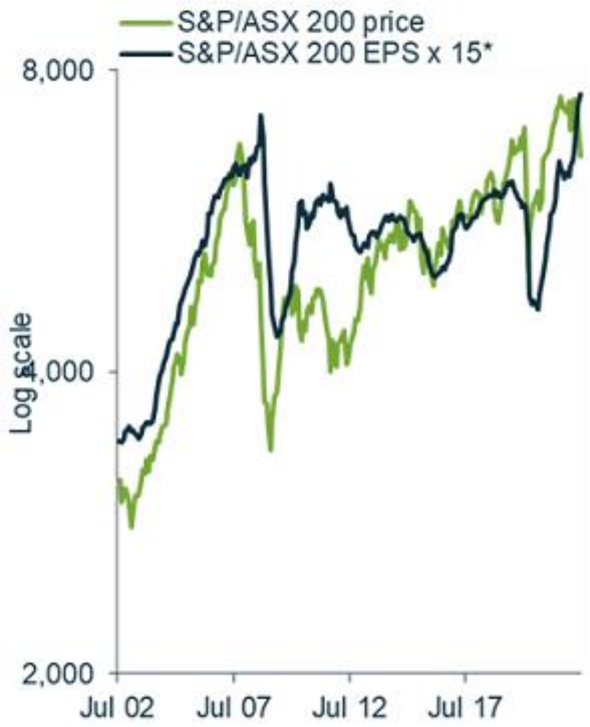
Six months ago, the tone of the February 2022 reporting season was overall positive, with the onset of reflation and higher rates being reflected in earnings upgrades, and a tilt away from the market's desire for Growth towards the Value-style stocks expected to benefit from the economic reopening.

Fast forward six months, and we have now seen blow-out inflation readings, central bank rate rises, a new Australian Government and a severe market correction in June. Australian share prices were down -10% since the start of the year to 30 June, yet earnings for S&P/ASX 200 companies are up at record levels as can be seen in the chart below. And while global economic growth indicators have been slowing for the last year, such as the purchasing managers index (PMI), they are still up above neutral levels.

Demand and profit expectations appear to be holding up despite inflation impacts growing, but the real question this reporting season will be, for how much longer.

To us, it is increasingly likely that headline inflation will soon peak and will be lower in 12 months' time, but rate rises are just beginning. Companies have, however, been slow to update guidance and we are yet to see the full impact of inflation expectations in their earnings and outlooks. We think we are in for a reporting season where supply and demand pressures will come further into focus.

Australian share market indicators



*Past performance is not guide to future returns. Source: Martin Currie Australia, FactSet; as of 30 June 2022. *Long term average P/E ratio for market.*

Differing short- and long-term impact on margins

While inflation is broadly good for equity profits in the long term, the short-term impacts will vary markedly across companies and have significant impact on margins for companies that lack pricing power for this environment. It is clear from all companies that we have been talking to that cost increases are a big issue.

At their core, many industrial businesses convert a primary material (bauxite, lime, clay) plus energy (gas, coal, electricity) into an end product (e.g., bricks, cement, alumina, steel). Where companies don't have direct pass through of cost inputs, they could face significant margin pressure.

Other industrial businesses, such as Amcor and Brambles, faced early-cycle inflation pressure from input costs in their US businesses but are also likely to see better profit margins as costs have started to roll over as the US brings inflation closer to target. We will also be interested to see if businesses with domestic supply chains that compete against imports can demonstrate a cost and supply advantage in the current environment to help them win share.

On the other hand, some contractors and real asset businesses have revenue contracts linked to CPI, or wage costs that are based on enterprise bargaining agreements (EBAs), are less inflation sensitive and hence will demonstrate strong margin expansion in the current environment.

For the banks, we expect higher rates to boost Net Interest Margins (NIM), especially the 'exit NIM' for the July or September quarters. Banks with large retail deposit bases will benefit the most. For general insurance, we are concerned by the significant supply chain and claims cost inflation, but premiums are now starting to outpace strong inflation. Financials in general will continue to face pressure on IT and wage rises next year will continue to impact their cost outlooks.

Australian rates (%)

Past performance is no guide to future returns. Source: Martin Currie Australia, FactSet; as of 30 June 2022.

Rate rise are still at early stage

The idea of central bank cash rate rises is really only eight months old, and the first Reserve Bank of Australia (RBA) move was just three months ago. We expect the RBA to tighten further in

August and September, and as this will occur during reporting season it is likely to impact company outlook statements.

Consumers and housing are highly sensitive to rates given high house prices, high indebtedness, and exposure to variable rates. There are already issues for profitability of house builders from cost increases, but the next issue will be falling new demand especially as immigration rates remain low.

Some types of REITs will also suffer demand destruction from higher build costs and falling new project return economics.

Full employment causing further inflationary pressure

We are also facing full employment, both in Australia and offshore, with low underemployment versus history. Wage inflation will be a multi-year issue to normalise and will require a significant slowing in employment demand to bring it under control and back towards the trend line shown on the graph.

We see that service companies and businesses with high wage costs will be the ones facing the largest wage inflation pressure for the longest period. We already saw tech companies suffering from wage pressure in February 2022 results. We expect to hear more this time around from Australian companies in this space.

The new Australian Government will hold a Jobs Summit in September which will likely focus on training and low skilled employment shortages (especially important for childcare) but this can do little to really readjust the pressures from full employment. To further slow the demand pressures on the economy, we expect that the next Australian budget in October will be contractionary, with expenditure cuts versus the last three years of expansionary budgets.

Confidence hit, taking spending with it

Plummeting business and consumer confidence highlights the consumer's sensitivity to inflation and interest rate issues. The consequences for the economy and companies have barely begun, but we certainly expect it to change consumers consumption mix, especially as we are yet to see the tight labour market discussed above translate to real wages.

While we believe the international travel recovery is just getting started and hence will be less economically sensitive, we believe higher living costs will result in declines in consumer discretionary categories that are trading well above pre-Covid trends.

CBA real-time credit card data highlights spending categories beginning to roll over to lower levels. Inventory levels will also be a potentially big cashflow issue for retailers, industrial and materials companies that held high inventories to protect against supply chain pressures but now may be stuck with excess stock as demand falls.

China concerns continue, but hopes from energy transition

China growth indicators also look terrible on the back of the burst property bubble. The only hope we can see is for their government to direct stimulus to the infrastructure sector and towards the consumer.

While we remain bearish on Australia's iron ore sector due to these China growth concerns, the resources super cycle is in fact benefiting from the Net Zero transition. We are keen to see significant improvements in the energy, construction and decarbonisation project pipeline that will benefit contractors such as Worley, Downer EDI and Monadelphous Group. Wage shortages and inflation are also expected to have a significant impact on miners' costs and new project capital expenditures.

We expect to hear a lot more discussion around the domestic energy crisis and energy transition. Results for electricity generators face a wide range of outcomes given risks around hedge books, contract positioning and supply disruptions. Whilst these issues will dominate FY22 and FY23 earnings revisions, by FY24 these companies will have large earnings upgrades given energy pricing.

Investment style implications from the shift

We discussed a continuation of the performance reversion for Value in a paper in April 2022, the tide continues to turn for the value-growth dynamic, and we expect that we will hear more positive earnings per share (EPS) stories from Value companies than Growth companies when they report in August.

Value stocks, typically resources, materials, financials, and utilities, are better placed for inflationary pricing power in a supply constrained world with growing demand.

The most attractive companies will be those that can insulate costs from inflation while enjoying an uptick in revenue from the rising prices across the economy. We will be particularly focusing on how management update their guidance in the face of short- and long-term inflation pressures.

Reece Birtles is Chief Investment Officer at Martin Currie Australia, a Franklin Templeton specialist investment manager. Martin Currie currently manages over $31 billion including $8 billion in Australian equities (as of 30 June 2022). Franklin Templeton is a sponsor of Firstlinks. This article is general information and does not consider the circumstances of any individual. Past performance is not a guide to future returns.

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The early signals for August company earnings

Rudi Filapek-Vandyck

The August 2022 corporate results season in Australia is upon us and genuinely builds after mid-month, but July and the opening week have already generated some valuable insights for investors.

We explore miners, property trusts (A-REITs) and asset managers.

Miners and resources

All too often forgotten, producers of copper, gold, oil and gas, and other commodities are themselves heavy consumers of diesel, steel, water, power, and other commodities.

That reality has started to show up in quarterly production updates from miners and energy producers. One sector on the ASX that has been heavily hit are the local gold producers, if only because gold has largely traded sideways this year, apart from a temporary spike as Putin's army crossed the border with the Ukraine.

Rising costs when the price of your main revenue source refuses to spike higher can only mean one thing: margin pressure, and lower profits.

And so it was, when sector analysts at Canaccord Genuity updated their modeling and forecasts at the end of July. Higher costs translate into higher investments for those companies looking to expand and into higher operational expenses when running daily operations.

Consider the following incomplete list of price increases the industry is dealing with:

- Diesel costs up 60% on average in Western Australia
- Steel prices are up 60% from one year ago
- Freight costs can be up to 400% higher
- Costs for drilling have increased by 15-20% in recent months.

No surprise thus, running higher operational costs and capex estimates through its modeling, Canaccord Genuity's valuations reduced by -24% on average for explorers and developers and by -26% for producers.

With no sustainable uptrend predicted for the price of bullion anytime soon, the underlying conclusion at UBS is pretty much the same:

"*...tempered growth ambitions, continued operating and inflation headwinds combined with our reduced price deck means stocks are not as cheap as they look.*"

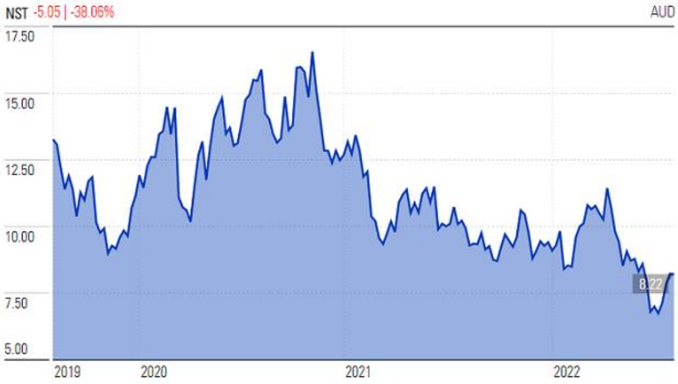
Share price falls do not mean 'buy'

Not every share price that has fallen represents a great opportunity for mid- to longer-term investing. The challenge for investors is to identify the real gems and the real quality in a basket that is full of pretenders.

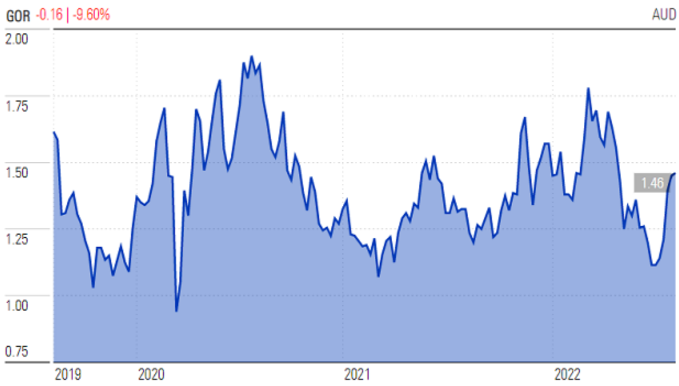
For what it's worth, UBS's favourites are Northern Star Resources (NST) among the large caps, because of the company's strong organic growth pipeline, and Gold Road Resources (GOR) among small caps. UBS analysts advise investors should focus on strong balance sheets, low risk growth and newer mines with a good runway and optionality still ahead.

(All charts in this article are sourced from Morningstar).

Northern Star Resources



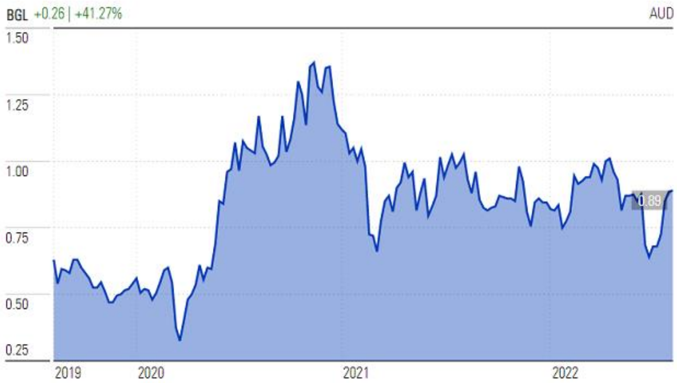
Gold Road Resources



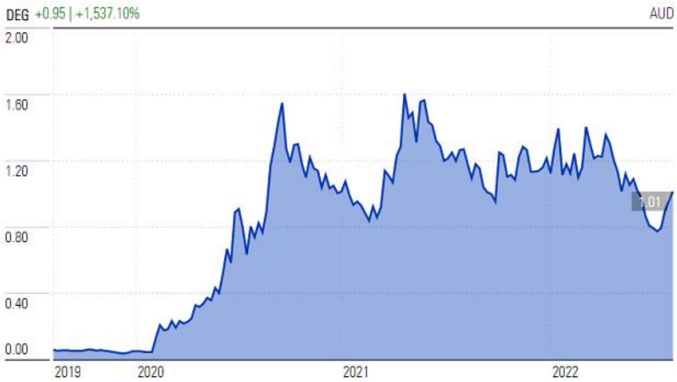
Canaccord Genuity's sector favourites are Bellevue Gold (BGL), De Grey Mining (DEG) and Predictive Discovery (PDI). All three have rallied off their June-July low.

Macquarie's favourites are Northern Star, Silverlake Resources (SLR) and Gold Road Resources among producers, as well as Bellevue Gold and De Grey Mining among juniors in the sector.

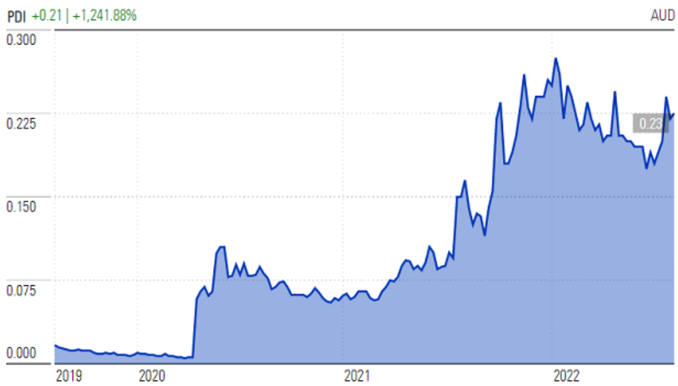
Bellevue Gold



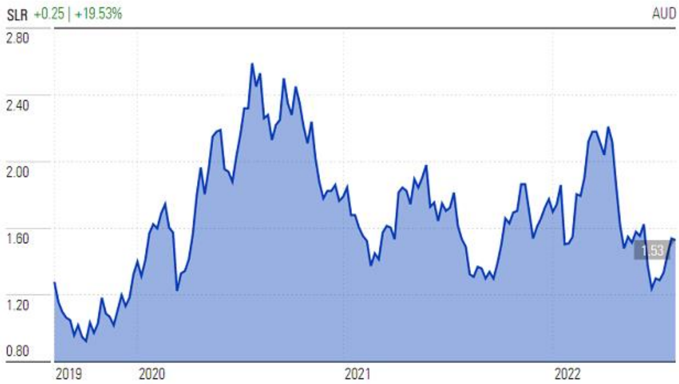
De Grey Mining



Predictive Discovery



Silverlake Resources



The cost-inflationary pressures that have dogged the gold sector this year equally apply for commodity producers elsewhere, as also shown by June-quarter trading updates released by sector heavyweights BHP Group (BHP) and Rio Tinto (RIO), as well as by the half-year report already released by the latter.

Canadian iron ore producer Champion Iron (CIA) also disappointed and higher-than-anticipated costs proved one important contributor.

OZ Minerals (OZL) is more a copper stock than gold but it equally disappointed with its quarterly update in July, but the share price recovered ahead of BHP Group launching an unsolicited, 'opportunistic' takeover bid for the company on Monday 8 August.

Combine all the above and the take-away message for investors might be that sharply weaker share prices may have already discounted a lot of the bad news, at least in the short term, but cost inflation remains a problem and is creating wide divergences inside sectors.

BHP's takeover attempt shows August this year won't just be about bottom line-financials and forward-looking guidance. Analysts are expecting at least some commentary about a bonus dividend from Woodside Energy (WDS), while Origin Energy (ORG) should continue its share buyback.

Woodside is also still looking to sell down its Scarborough project, while Santos (STO) might soon announce new ownership for its non-core asset in Alaska, and potentially for its equity in PNG LNG too.

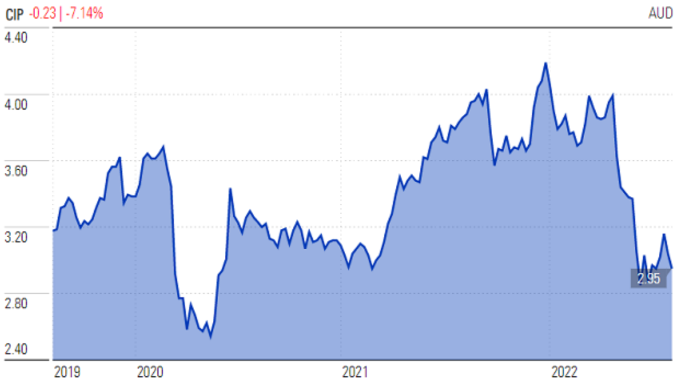
Note to us all: the threat of economic recession has not dissipated. The odds are shortening that Europe and the USA will join the UK in falling GDP in the months ahead.

Australian Real Estate Investment Trusts (A-REITs)

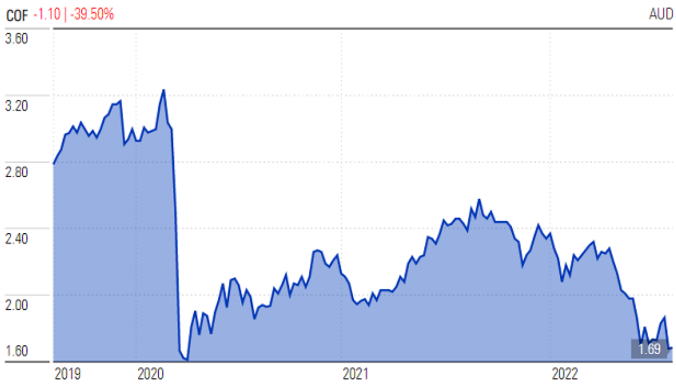
Another sector that has equally landed under close scrutiny is local real estate investment trusts, A-REITs, many of which have recently experienced significant price falls.

The early part of the earnings season saw both Centuria Industrial REIT (CIP) and Centuria Offce REIT (COF) releasing FY22 financials and while the former met forecasts and offers optimism now the share price has weakened significantly year-to-date, the latter disappointed and sees investors and sector analysts continuing to adopt a more cautious approach.

Centuria Industrial REIT



Centuria Offce REIT

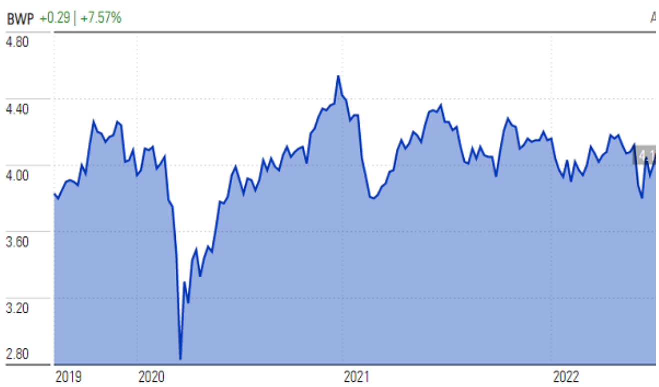


What both REITs have in common is management at each trust has adopted a cautious approach regarding the rising cost of debt, which could become somewhat of a Sword of Damocles hanging over this sector for the year(s) ahead.

In simple terms, the market has taken what seems a rather dire view as to how high the **weighted average cost of debt (WACD)** can rise over the coming three years. While more optimistic sector analysts can thus see 'value' in the sector, others think the market's pricing seems but a realistic scenario.

The real estate analyst at Barrenjoey, Ben Brayshaw, is among the least enthusiastic. He thinks REITs will meet FY22 forecasts in August, but the outlook is for reduced growth, reduced profits, and reduced payouts for the sector on average. Issues range from rising costs, to deflating property markets, to the threat of less consumer spending, to still struggling office assets, to less opportunities for acquisitions, to higher headwinds from servicing debt.

BWP Trust



REITs were firmly in focus throughout week one, with Bunnings landlord BWP Trust (BWP) mid-week reporting "strong fundamental performance" and "prudent positioning", but given BWP just about always trades at a sizeable premium versus the rest of the sector, analysts simply cannot get excited, and this includes the perceived risk profile for the Trust.

The sector as a whole is often described as a beneficiary of higher inflation (as leases are often tied to CPI), but the first three financial results this season have proved this narrative is too simplistic for general purpose.

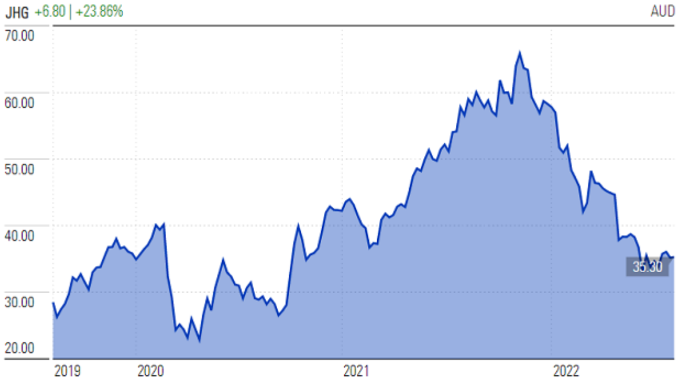
Asset managers

The first week also saw two asset managers releasing FY22 results and the outcome could hardly have been more different.

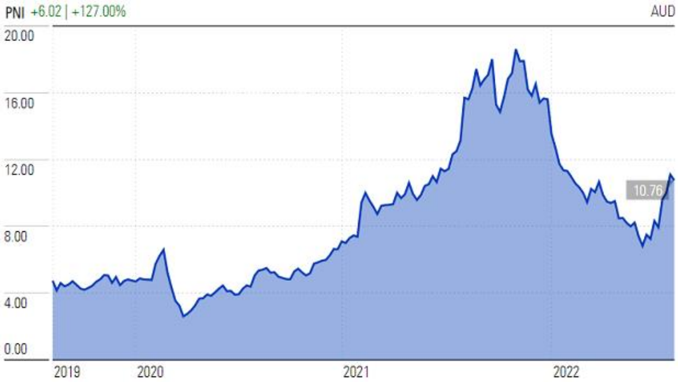
In one corner we find Janus Henderson (JHG) struggling to keep investor funds from departing while share markets in general are likely to face ongoing subdued momentum as the threat of economic recession continues to loom large.

In the other corner sits Pinnacle Investment Management (PNI), the umbrella group that includes affiliates such as Firetrail Investments, Hyperion Asset Management, Metrics, Plato Investment Management and Solaris.

Janus Henderson



Pinnacle Investment Management



Pinnacle is enjoying more popularity than its peers this year, making the impact from sector-wide selling on its share price pre-FY22 release looking extremely silly. But as the price chart shows, the market is addressing that situation recently.

Maybe the take-away message at the start of a busy reporting season is that individual strength can overcome general sector malaise.

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

The compelling 20-year flight of SYD into private hands

Stuart Cartledge

The successful completion of the takeover of Sydney Airport (when listed, ASX:SYD) in March 2022 marked the conclusion of 20 years as a listed entity. The journey was long and colourful, with many lessons learned along the way in terms of aviation, finance, governance and politics. Since the inception of the Cromwell Phoenix Property Securities Fund (the Fund) in April 2008, Sydney Airport was a core holding and a big positive contributor to the Fund's returns. This article distils the journey into a short read, with all puns intended.

Running out of runway in a turbulent first year

In the aftermath of the September 2001 terrorist attacks on the World Trade Centre and the subsequent demise of Ansett in March 2002, Macquarie Airports (then ASX:MAP) listed on the Australian Stock Exchange on 2 April 2002. Timing is everything!

Macquarie Airports, which many years later would Sydney Airport, started life as an externally managed fund with a mandate to invest in airport assets in Australasia and Europe. The seed asset was a 36.7% stake in Macquarie Airports Group Limited, which gave Macquarie Airports an 18.4% exposure to Bristol Airport and an 8.9% exposure to Birmingham Airport, both in the UK.

The other significant attribute at inception was its participation in the Southern Cross Airports Corporation consortium which was Macquarie Bank's bidding vehicle for the privatisation of Sydney Airport.

The Macquarie Airports initial public offering (IPO) raised a whopping $1 billion. Partly to reflect the size, and partly to give Macquarie some flexibility, the deal was structured in the form of partly paid shares, with $500 million raised upfront in April 2002 at $1 per unit, and a second call of $1 per unit, payable in September 2002 to raise an additional $500 million.

The stock listed at a small discount to its issue price and then commenced a glide path. Unless there are extremely favourable thermals, glide paths rarely point upwards.

On 25 June 2002, the Australian Federal Government announced that the Southern Cross Airports Corporation Consortium had won the bid to privatise Sydney Airport. Macquarie Airports, via its 40% direct stake in the winning consortium and also indirectly via its stake in Macquarie Airports Group, also part of the consortium, became a 44% investor in Sydney Airport.

Winning bid takes off but not the share price

The winning bid comprised $5.396 billion for the airport, and a further $192 million for the Ansett terminal. This was considered colossally high at the time and the market price of Macquarie Airports reacted negatively.

The price paid represented a multiple of 14.3 times forecast June 2003 earnings before interest, tax, depreciation and amortisation (EBITDA) of $377 million and a forecast project level internal rate of return of 12.1%. Given the geared structure of the consortium, the direct equity cost to Macquarie Airports for its 40% stake in the consortium was $815 million.

Not deterred by a slumping unit price, on 16 July 2002, Macquarie Airports announced a second large acquisition, also via a Macquarie consortium, for the purchase of a 28% stake in Aeroporti di Roma which owned 100% of the Rome airports Fiumicino and Ciampino.

Given the acquisitions of stakes in both Sydney and Rome in quick succession, plus Macquarie's appetite for fees, the transaction also required a further capital raising, this time at $1.50 per unit on a fully paid basis (compared to the $2 initial price, paid over two instalments). Rome's profit for the half year to June 2002 was initially poorly received by the market, albeit a little misunderstood. This subsequently sent the Macquarie Airports unit price lower ahead of the final call of the initial IPO stock.

The day before the call was due, the unit price hit 16.5 cents, with many investors worried about what had happened to their original $1 investment. So much so, that approximately 58 million of the original 500 million units failed to make the second payment, and Macquarie Equity Capital Markets was forced to take up the stock and sell it into the market.

As we subsequently moved into 2003, the effects of SARS (the first one) and the Iraq War combined to drive Macquarie Airports lower. At its low, the $2 fully paid IPO stock touched 80 cents before commencing what would ultimately become a staggering rally.

In July 2003, Macquarie Bank, in recognition of the tumultuous journey that investors had been on since listing, announced a waiver of performance fees due in respect of Macquarie Airports. Furthermore, future performance fees would also be waived until such time as investors had accumulated returns above the Morgan Stanley Capital Index World Transportation Infrastructure Index (the Benchmark). A mark of confidence indeed.

While the share price had not climbed above its fully paid IPO price by the time of the first full year results call in August 2003, the company was able to demonstrate that Sydney Airport's EBITDA figures were in line with the assumptions made on acquisition, despite international traffic impacted by SARS and the Iraq war. The underlying performance of the assets was crucial to management credibility and to support the strategy of developing a portfolio of airport stakes.

In for the long haul as the mix changes over time

Over the next decade, Macquarie Airports, along with partners (predominantly other Macquarie vehicles), bought a portfolio of airport stakes with positions peaking in assets including Rome Airports (34.2%), Brussels Airport (62.1%) and Copenhagen Airports (53.7%). However, the jewel in the crown, the position in Sydney Airport continued to grow and by the end of December 2011, Macquarie Airports controlled 85% of Sydney Airport and through a series of transactions the position had become the sole asset in the portfolio. The table below sets how the stakes changed through time.

	Sydney Airport	Copenhagen Airports	Brussels Airport	Bristol Airport	Japan Airport	Rome Airports	Birmingham Airport	Mexico
31-Dec-02	44.7%			18.3%		28.0%	8.8%	
31-Dec-03	53.0%			20.1%		28.8%	9.7%	
31-Dec-04	55.5%		53.3%	30.8%		33.6%	14.9%	
31-Dec-05	55.8%	52.8%	52.0%	32.1%		34.2%	15.5%	
31-Dec-06	55.8%	53.4%	53.9%	32.1%		34.2%	15..5%	
31-Dec-07	72.1%	53.7%	62.1%	32.1%	14.9%	0.0%	0.0%	
31-Dec-08	72.1%	26.9%	36.0%	35.5%	14.9%	0.0%	0.0%	
31-Dec-09	74.0%	30.8%	36.0%	0.0%	0.0%	0.0%	0.0%	16.0%
31-Dec-10	74.0%	30.8%	39.0%	0.0%	0.0%	0.0%	0.0%	0.0%
31-Dec-11	84.8%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
31-Dec-12	84.8%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
31-Dec-13	100.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%

In 2009, after the GFC demonstrated some of the conflicts of externally managed vehicles, the board set out a proposal to pay Macquarie Group $345 million to internalise Macquarie Airports. This was highly controversial, given shareholders could theoretically terminate Macquarie by a majority vote, and alternative proposals were put forward.

However, the board persisted with the plan, arguing the need for Macquarie’s co-operation to avoid triggering change of control and pre-emptive rights clauses in debt facilities and shareholder arrangements. Ultimately the internalisation occurred, with the Chairman at least being forced to acknowledge that there was no legal obligation to pay Macquarie, just a moral obligation.

A very expensive ‘moral’ obligation in our view.

Despite the bumpy path, by the end of the 2013 calendar year, Macquarie Airports had internalised to become Sydney Airport, the business was simplified, a tax dispute settled with the ATO, and ownership of Sydney Airport had moved to 100%. From a share market perspective, simple is good.

Despite early turbulence, the vision was clear

From the early days, the potential upside of airports made for a compelling investment case. Airport ownership provides a myriad of opportunities to invest in commercial activities, particularly via the unregulated retail, car parking and property opportunities, which combined can often represent a greater proportion of airport revenues than aeronautical activities.

With respect to aeronautical activities, the privatisation of Sydney Airport was accompanied by the removal of price controls on aeronautical charges, enabling more flexible arrangements between airlines and the airport allowing for the provision of services to meet the demands of airlines.

Accounting tricks aside, airports require lots of capital and it is often difficult to determine what is regular maintenance capital and what capital is required to grow revenue. However, on acquisition of Sydney Airport, we took comfort that it had been the recipient of lots of capital in the process of getting Sydney and its infrastructure ready to host the Sydney 2000 Olympics.

Another appealing feature of Sydney Airport has always been the monopolistic nature of the asset. In a geography as vast as Australia’s, unlike in Europe, there really is only one way to efficiently travel between major capital cities. This is somewhat supported by the Sydney-Melbourne route being the third most busy airline route in the world.

Furthermore, the only moderate level of future competition was in the form of Western Sydney Airport, where Sydney Airport always had the right of last offer to participate. With light-handed regulation and a focused management team, good things happened.

Aggressive financial structure in the early days

Love it or loath it, Macquarie Airports started life as a complex triple stapled structure that invested in other complex structures, making the accounts opaque and difficult to understand. Couple that with a new asset class and many investors struggled.

In Macquarie Airports' early days, financial leverage was also considered to be high, particularly for an asset with plenty of operational leverage. The initial Southern Cross Airports Corporation consortium that won the bid for Sydney Airport was aggressively structured as shown in the table. Less than a third of the capital to fund the acquisition was pure equity.

Sources	$m	Uses	$m
Senior debt	3,744	Acquistion price	5,396
Convertable preference share	600	Ansett Terminal	192
Equity	1,931	Cash (reserves)	500
		Other costs	187
	6,275		6,275

Correct flight path

In the 2002 calendar year, the company's cash generation before interest was sufficient to cover its interest bill by 1.2 times. That provides little margin of safety. By contrast, that same ratio was over three times by the end of the 2019 calendar year. The steady improvement in balance sheet strength enabled the company to weather most storms, including the GFC. Only the devastating impact of COVID-19 resulted in an equity issue to bolster the balance sheet.

The decision to focus on Sydney Airport stands the test of time. Based on Phoenix Portfolios calculations, setting aside recent COVID-impacted financials, for the 18 years ending December 2019, Sydney Airport generated a cumulative annual growth rate in revenue of 8.5%, and given margin expansion throughout the period, an EBITDA growth rate of 10.3% per annum.

This didn't come for free. Phoenix estimates over $5 billion was spent over the last 20 years on various capital projects that have facilitated passenger growth and contributed to the spectacular EBITDA growth. In addition, a further $2 billion of capital was injected into the business by shareholders to cope with the difficulties thrown up by COVID-19. However, offsetting this has been a steady and robust stream of distributions.

Grounded, but ready for take-off again

Sydney Airport has enjoyed some magnificent tailwinds through the last 20 years, which combined with an active management approach has grown EBITDA by 350%. The robustness of the cash flows, along with steadily declining interest rates, has facilitated high multiples when valuing such assets.

On 5 July 2021, Sydney Airport received a proposal from a consortium of infrastructure investors called Sydney Aviation Alliance to acquire, by way of scheme of arrangement and trust scheme, 100% of the stapled securities in Sydney Airport. The Consortium comprised:

- IFM Investors (Nominees) Limited as trustee for IFM Australian Infrastructure Fund;
- Conyers Trust Company (Cayman) Limited as trustee for IFM Global Infrastructure Fund;
- QSuper Board as trustee for QSuper; and
- Global Infrastructure Management, LLC (on behalf of its managed and advised clients and funds).

This transaction was ultimately consummated on 9 March 2022 with a payment of $8.75 per stapled security. This reflected an Enterprise Value for Sydney Airport of approximately $32 billion.

	Jun-02	Mar-22
Enterprise Value ($bn)	5,400	32,300
Projected EBITDA (2003)	376	
Historic EBITDA (2003)		1,333
EV: EBITDA	14.4	24.2
10 year bond rate	6.00%	2.88%

As shown in this table, we believe this transaction fully values the asset.

Going forward, Sydney Airport must navigate its way out of the COVID-19 pandemic, deal with potential structural changes to the aviation market, contend with rising interest rates and the opening of Western Sydney Airport. We believe these challenges can be managed but the returns are unlikely to be as robust as the last 20 years.

Phoenix estimates the internal rate of return of an investment in Sydney Airport from the IPO to the sale in March 2022 was approximately 17.9%. By comparison, the S&P/ASX 300 REIT Accumulation Index returned 6.5% over the same period. Since the inception of the Cromwell Phoenix Property Securities Fund, the Sydney Airport holding has delivered an annualised return in excess of the property benchmark by approximately 10%.

Stuart Cartledge is Managing Director of Phoenix Portfolios, a boutique investment manager partly owned by staff and partly owned by ASX-listed Cromwell Property Group. Cromwell Funds Management is a sponsor of Firstlinks. This document provides factual information only and does not provide any opinions, advice or recommendation, nor does it consider your personal circumstances.

View the full report here.

Ethical investing responding to some short-term challenges

Angus Dennis

While Australian equities have long played a key role for investors with a responsible investment approach, 2022 has created conditions that have placed the sector squarely in focus.

Managers offering funds with a responsible investment approach have had to navigate performance headwinds linked to rallying materials and fossil fuel companies in an environment of increased inflation and constrained energy supply.

At the same time, other key strategic areas have also emerged. Investors and other industry participants are placing more consideration on the importance of fund managers being true-to-label. From ethical to ESG (Environmental, Social and Governance factors), managers are subject to greater scrutiny on their delivery of stated product. We are seeing greater importance around company transitions to net zero emissions, and the recent change in Federal government and the new wave of elected independents has seen rejuvenated ambitions for the net zero journey in Australia.

How do Australian equity funds with a responsible investment focus deliver for clients from both a social and environmental perspective in the context of investment performance? For the responsible investor both elements matter, and for Australia and our pathway to net zero, the effective operation of responsible investment has never been more important.

Delivering on social and environmental outcomes

Responsible investors are seeking closer alignment between their expectations of the fund they invest in and the real-life outcomes of the investment activity of the fund.

There are two key metrics to assess a fund on its social and environmental focus:

1. Company holdings - which companies are included and which are excluded?

The Australian share market is characterised by relatively high concentrations to sectors like financials and materials. Add to that individual company performance on environmental and social issues ranges from leader to laggard, and company holdings can vary materially between each responsible investment fund provider.

A common strategy used by managers today is considering ESG factors as part of the financial analysis step of the investment process, known as 'ESG integration'. In 2020, 57% of Australian fund managers cited they have at least 85% of assets under management assessed using ESG integration.

A pure ESG integration approach, in the absence of negative screens, won't stop the fund investing in a business that offers products with harmful effects if the manager thinks the company share price accounts for the additional risk. ESG portfolios tend to also be more benchmark-aware through lack of strict fund exclusions.

In the case of ethical funds, where strict company, asset and sector exclusions are applied, there are clear differences in stock holdings with the scale of any difference dependent on the screening process, including materiality.

2. Creating an environment for positive change

The second element in selecting an ethical fund is how the manager supports creating an environment for positive change.

In 2022, there is much debate around effective ways to transition companies and their assets in the move towards net zero targets. A manager adopting an ESG-oriented approach can have a broad list of company holdings which can assist engagement with those companies, supported by dialogue with management and via proxy voting.

An ethical manager can direct capital to support a portfolio of companies that meets its social and environmental criteria, engage with businesses to raise their standard for inclusion and keep current companies accountable with an ability to divest. Also, there is proxy voting on those companies held, and opportunities for industry engagement.

From Australian Ethical's perspective, we also employ a dedicated Ethics Research team, so we can encourage action in areas that matter most from a social and environmental perspective and adopt a public voice on key issues. Our transparent exclusions can have a signalling effect to conscious consumers and companies concerned about their brand. For example, our recent decision to invest our equity portfolios to line with net zero by 2040 also has the effect of seeking to encourage more rapid change from market participants.

Delivering investment performance faced with energy and inflation changes

Responsible Australian equity funds face additional challenges linked with the present inflationary environment that is driven by factors such as the Covid pandemic and supply chain restrictions, labour shortages, the war in Ukraine and spikes in energy prices. The recent rise in bond yields has also made for a more difficult environment.

We believe in adopting a patient approach to equity market investments with a focus on the long-term. Many of the better-performing ASX companies over the last year were from the materials sector or involved with fossil fuels, while the performance of smaller innovative companies has detracted from recent returns. Another way of stating this is that markets have been 'voting' for energy companies and against smaller growth-oriented businesses.

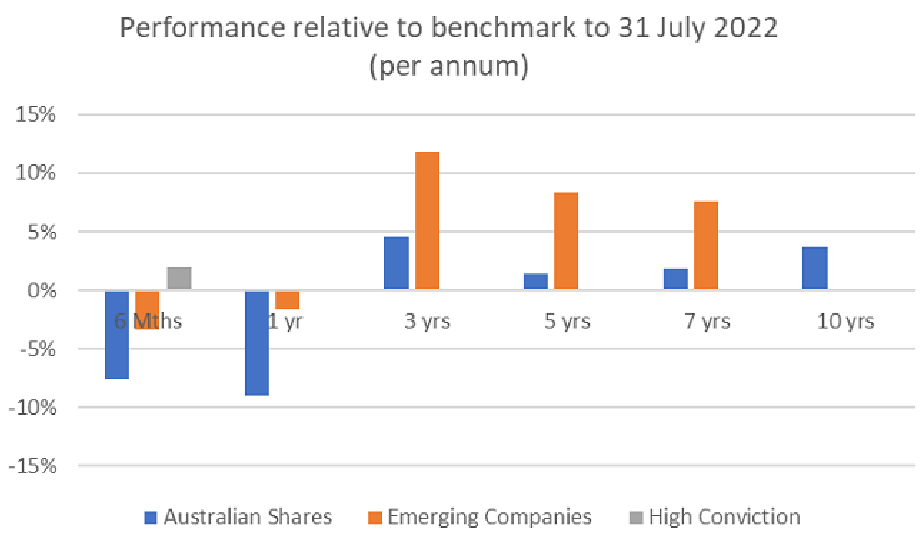
Looking at 2022, in the seven months to 31 July 2022, we saw the broad market (as represented by the S&P/ASX300) fall -5.1% while the energy sector returned +31.9%, which was the highest returning and one of the only three sectors delivering positive returns. And small industrials has had a negative return of -17.1%.

As an ethical manager, our nil holding in energy - largely driven by our fossil fuels exclusion - hurt returns, and a material overweight to those small industrial companies significantly impacted short-term relative performance.

Exclusions will remain in place regardless of company valuations and financials. We take a strategic view and back our expertise in selecting companies approved for investment. We believe our broader focus on company assessment will support better long-term investor outcomes.

The chart below shows the performance across our Australian equity fund wholesale fund range after fees relative to their benchmarks. The chart demonstrates some significant headwinds over 6 and 12 months for our broad cap Australian Shares Fund (which has a material overweight vs benchmark in small companies), but it has delivered long-term competitive returns. (There is also a retail unit class of this Australian Shares Fund with a longer track, which has outperformed its benchmark by 2.7% p.a. after fees over 20 years to 31 July 2022, returning 10.2% p.a.)

Our additional Australian equity strategies – the long-standing Emerging Companies Fund (small cap) and recently launched High Conviction Fund (large cap) - have incurred less impact from key moves in 2022 relative to benchmark, in particular linked to not having the small cap overweight. We think having a blend of large and small cap-oriented strategies can also support outcomes for ethical investors across a range of market conditions.

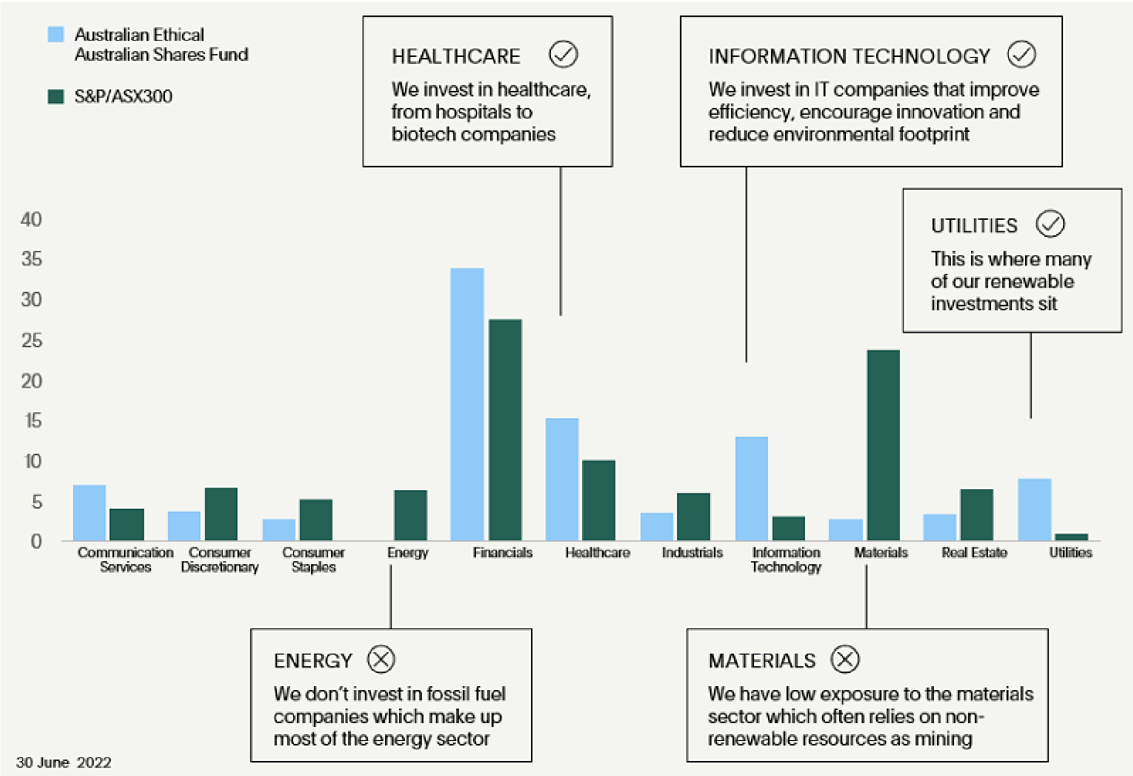


Long-term value and divergence from indexes

Our expertise in small companies and in specific sectors - such as healthcare, IT and renewables - positions us to add long-term value. For example, we have followed a relatively unknown company called Cogstate for a long time. They are a global player in digital cognition testing technology relating to Alzheimer's research. In 2019 we took a meaningful stake in their business at 17.5c. Despite recent falls in their share price, at the end of July 2022, shares were trading at $1.80 and we continue to see a bright future for the business.

In general, our active equities portfolios are underweight in classically cyclical companies such as resources and consumer discretionary names, which we think positions our funds well for any slowdown in economic growth. While resource companies have initially responded positively to inflationary concerns, given the inherent cyclicality of this sector, concerns around rising interest rates and impact on aggregate demand and commodity prices is starting to impact returns. Furthermore, in the case of fossil fuels, currently high prices are likely to incentivise more environmentally friendly substitutes in the long term.

Our ethical framework can be evidenced from our different company and linked sector weightings. Only about 50% of companies in the S&P/ASX300 index earn environmental and social approval from our Ethics Research team. The diagram below shows the sector allocations of our Australian Shares Fund versus the benchmark S&P/ASX300 index.



Conclusion

Responsible investment in Australian shares is more critical now than ever. Clients want to ensure that funds are being true-to-label, delivering from both a social and environmental perspective, plus offering long-term competitive performance. Trends in 2022 have only re-emphasised the importance of this dual focus, for investors, financial and responsible investment industry participants, and our nation alike.

Angus Dennis is Investment Director at [Australian Ethical](), a sponsor of Firstlinks. This information is of a general nature and is not intended to provide you with financial advice or take into account your personal objectives, financial situation or needs. [View full disclaimer and other important information]().

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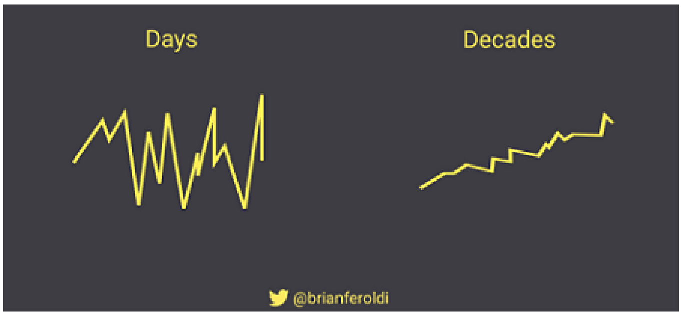
If you are new to investing, avoid these 10 common mistakes

Brian Feroldi

I see new investors making the same mistakes again and again. New investors should focus on avoiding big mistakes, not on being brilliant. Here are 10 common mistakes of the uninitiated:

1: Short-term mentality

New investors are easily fooled by market randomness. Stock UP this week? “I’m a genius.” Stock DOWN this week? “Investing is impossible.” Experienced investors know that stock returns should be measured in years, not days.



2: Going 'all in' on one stock

New investors focus on the upside. They become convinced that they can’t lose and over-allocate to a single position. Experienced investors diversify, knowing that the future is uncertain and that no stock is guaranteed to succeed

3: Not doing any research

New investors buy stocks without doing enough research. Many don’t even know how to do the research. Without research, you don’t have conviction. Without conviction, you won’t have the strength to hold through the inevitable downturn.

4: Not taking care of their personal finances

New investors think that buying stocks will fix their personal finances. They quickly learn that stocks are volatile and handling that volatility is hard. Experienced investors make their personal finances rock-solid first.

(Note for Australian readers: 401 (k), HSA and IRA are roughly equivalent to our superannuation accounts).

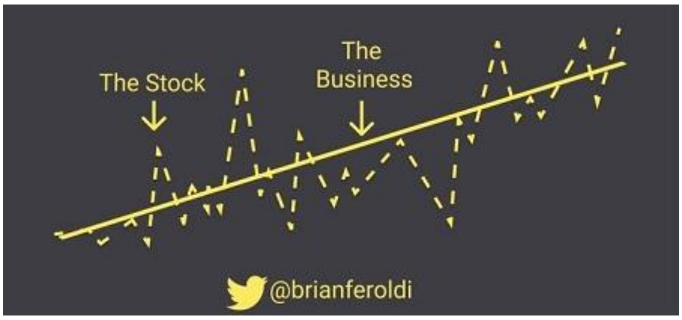
Financial Wellness Order Of Operations

1:	Track Income, Expenses, & Net Worth	9:	Max IRA (ROTH or Traditional)
2:	Appropriate Insurance Coverage	10:	Pay Off All Non-Mortgage Debt
3:	Align Spending With Your Values	11:	Max Retirement Account
4:	1-Month Emergency Fund	12:	Fund Kids' Education (If Applicable)
5:	Pay Off High-Interest Debt	13a:	33% To Taxable Brokerage Account
6:	401(k) Up To Employer Match	13b:	33% To Mortgage Paydown Fund
7:	3 - 6 Month Emergency Fund	13c:	33% To Irregular Expense Fund
8:	Max HSA (If Applicable)	14:	Whatever You Want!

@brianferoldi

5: Watching the stock, not the business

New investors focus intensely on minute-by-minute price movements. Experience investors focus intensely on company earnings reports and their estimate of the company's intrinsic value.

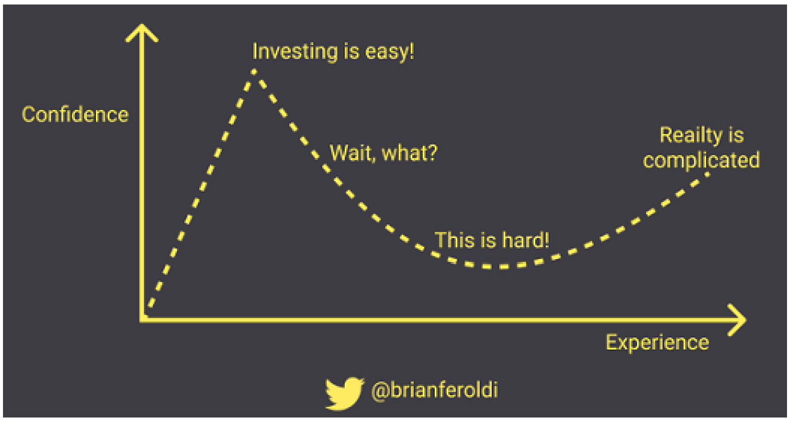


6: Selling winners to buy losers

New investors sell their winners and double-down on their losers. Experienced investors know that the opposite strategy is much more effective.

7: Overconfidence

New investors are filled with confidence. Experienced investors know that the more they learn, the more they realise they don't know. (I followed the Dunning-Kruger effect).

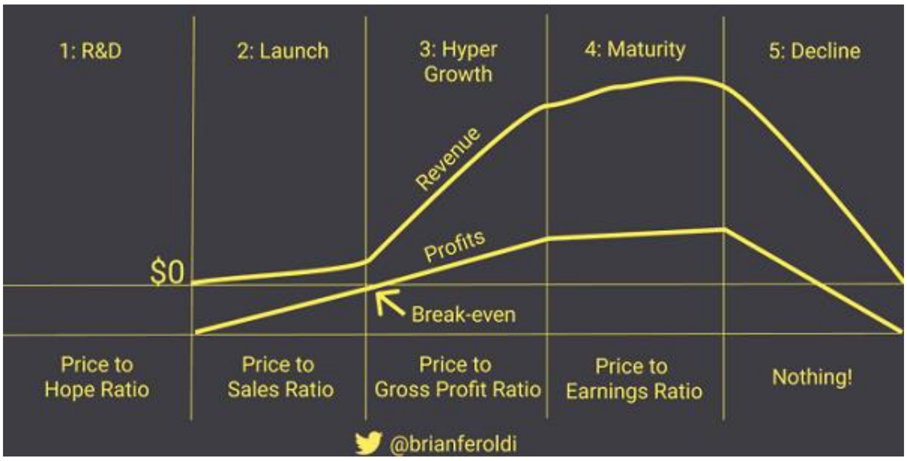


8: Not having a process

New investors just start buying and selling whatever stocks are popular. Experienced investors focus intensely on their investment process and make use of an informed process:

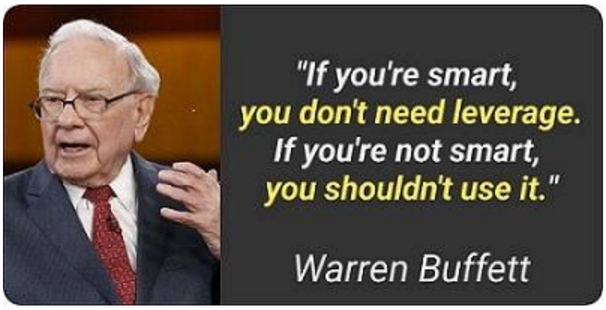
9: Overusing the P/E ratio

New investors use the P/E ratio to make valuation decisions. Experienced investors know the P/E ratio has huge flaws and it is only useful in phase 4



10: Using options, margin and leverage

New investors are in a rush to build wealth. They use options, margin, and leverage to juice their returns. Experienced investors know this is a recipe for disaster. Never forget Buffett's quote:



I personally have made every mistake on this list

[This thread from 30 October 2020](#) shows how bad I was at investing when I first started:

When I started 'investing' in 2004, I had no idea what I was doing. I couldn't tell you anything about a balance sheet, income statement, management. To prove just how bad I was, I looked up the first stocks I bought in 2004-2007.

Here's how it went ... (*stocks referenced are US companies)*.

Stock #1 - $STEM
I heard stem cells were going to be big, so I bought this penny stock. The only thing I knew was the ticker - that's it! I sold it for a 20% gain in a few months. My feelings: Investing is easy!

Stock #2 - $DIGI
Another penny stock. I couldn't tell you ANYTHING about this company either. Bought for $1.40 and sold a month later a 5% loss. My feelings: Investing is still easy! (currently about $0.10 share, down 90%).

Stock #3 - $ALT
Penny stock, I can't tell you anything about this company. Bought $1.01, sold a month later at cost. My feelings: Investing might not be easy. ($ALT is unlisted today).

Stock #4 - $UAIR
Penny stock and a company I know! I can't lose! Bought for $1.13. Sold for $0.75 three days later! My first 'big loss'. My feelings: Investing is getting harder

Stock #5 - $VODG
Penny stock bought for $0.18 (So cheap, how could I lose?). Sold for $0.20 one month later. My feelings: Investing is easy again!

Stock #6 - $DDD
Another penny stock, a clinical-stage biotech at the time, not 3D Systems. Bought at $3.15. Sold three months later at $4.50. My feelings: Investing is so easy. Who are these suckers that buy 'high priced' stocks?

Stock #7 - $DDD again
Back to old reliable! Bought at $4.83 (higher than my 1st sale price). Bought again at $3.50 (what a bargain!). Sold for $1.30 (biggest loss to date!). Eventually becomes unlisted. My feelings: Investing sucks sometimes! No more penny stocks for me - too risky!

Then I screened for stocks based solely on trailing dividend yield. Nothing else, so bring on the huge dividends.

Stock #8 - $CIF
12% dividend. How can I lose? Bought $3.21. Sold $3.11. My feelings: Dividends!

Stock #9 - $IMH
22% dividend yield. I really can't lose now! Bought $17.05 (expensive). Sold $17.60 three months later (luck). (Current price $1.40) My feelings: Dividends!

Stock #10 - $PURE
Back to clinical-stage biopharma penny stock that's going to the moon! Bought $1.90, $2.30, $2.40, $2.10. Sold $4.65 & $3.13 (success!) My feelings: I'm getting better at 'investing'!

Stock #11 - $CLM
What's it do? No clue. 20% dividend! Bought at $9.15. Sold one month later at $8.20. My feelings: What aren't these dividend stocks working?

The good news

I then consumed every piece of financial content that I can get my hands on at this time. Rich Dad Poor Dad, The Millionaire Next Door, etc. I discover buying 'good' companies is the way to go.

I buy $EBAY, $GE, $BAC, $GOOG. I buy ETFs like $QQQ, $EEM.

Peter Schiff and Robert Kiyosaki convinced me that inflation is going to make the dollar worthless, so I buy $GLD, $SLV, $SLW and foreign stocks.

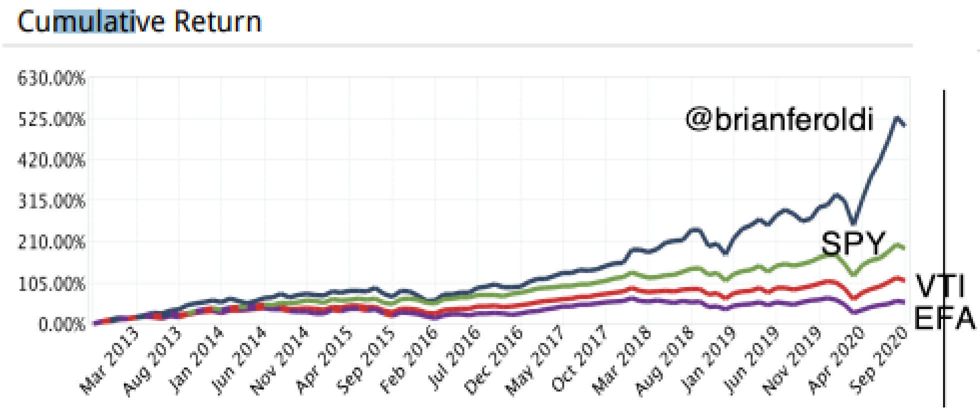
I still like dividends, so I buy $BP, $MO, $CVX, $PAYX.

I continue to read, read, read, read, read.

I start to buy more good companies like $NFLX, $AMZN, $GOOG.

I start to develop a long-term mindset. I start to read @morganhousel and learn about market history and psychology. I abandon my desire to own gold/silver/oil.

My results since:



It's OK to suck in the beginning. I sure did! Get some skin in the game, make mistakes, and learn from them.

Connect with other investors, and develop a system.

Most of all, develop a long-term mindset. Invest, don't trade. Let's all get better, together!

Brian Ferodi is a US author who tweets @brianferoldi and writes a free weekly newsletter available here. This article is general information and does not consider the circumstances of any investor. Publication here is not an endorsement of the investment strategies described.

RMBS today: rising rate-linked income with capital preservation

Ashley Burtenshaw

Today's environment with heightened volatility and risk, interest rate increases, and inflation concerns has investors (institutional and retail alike) scrambling for safe havens amid such uncertainty. For those, like retirees, who need income with strong capital preservation from their investment portfolio, an allocation to Australian Residential Mortgage-Backed Securities (RMBS) could provide both high risk-adjusted income returns and comfort.

Traditionally, RMBS were only available to institutional investors, and in some cases, so called 'wholesale' investors, but they are now increasingly available to retail investors through various funds.

RMBS explained

RMBS are bonds that are backed by pools of residential home loans.

The loans are packaged up into bonds issued by banks (including the big four) and non-banks, and this process is known as securitisation. The bonds are issued in a number of classes (or tranches) with different risk/return profiles. In any given deal, the vast majority (over 90%) of the bonds will be triple-A rated, with the lowest risk and lowest return. It is not unusual to see six classes of bonds with different ratings from triple-A through triple-B and down to unrated, with higher returns as the risk goes up.

Banks use securitisation because it frees up capital for further lending while they retain interest in the profitability of the underlying loans whereas non-banks use securitisation for funding purposes.

Securitisation has been a feature of the Australian financial landscape for over 30 years. As banking regulations have tightened, it has become a more important part of a bank's funding as regulatory changes make it is less attractive for banks to keep loans on their balance sheet for their full life.

Inflation protection and capital preservation

RMBS are issued as floating rate notes. This means that the interest they pay is linked to current interest rates, and as the Reserve Bank (RBA) increases cash rates, the interest rate on the RMBS increases providing protection from rising interest rates. This means that RMBS are inflation protected.

Investors are attracted to these bonds due to their diversification benefits and attractive returns. The underlying loan pools are highly diversified and consist of thousands of loans.

Australian RMBS have uniquely strong capital preservation characteristics because there are four investor protections in RMBS:

- Home-owners' equity
- Lender's Mortgage Insurance (LMI)
- Excess interest, and
- Originator takes first loss position.

Let's consider these four levels of protection.

1. Home-owners equity

When an individual buys a house with a mortgage loan, they put in some equity to protect the lender from a fall in house prices. On average, for the RMBS investments of Gryphon Capital Investments (GCI), this is about 35% of the value of the house. This means that house prices need to fall by 35% or more for there to be a risk of loss to the loan (and therefore the RMBS) if the home-owner defaults.

A research study by the RBA notes that for the borrower to default they need to be in negative equity AND suffer a loss of ability to pay such as unemployment. As a result, mortgage defaults are very rare in Australia. That's the first investor protection.

2. Lenders Mortgage Insurance (LMI)

For RMBS, LMI is often taken up to cover mortgages with a loan to value ratio (LTV or LVR) of over 80%. In the event of a default and after the sale of the house, any shortfall is claimed back from the LMI provider subject to the terms of the insurance contract. This is the second investor protection.

3. Excess interest

When a pool of mortgages is securitised into RMBS, the average interest rate on the loans is higher than the average interest rate on the bonds issued in the RMBS. This excess interest or bank's profit is a big reason why banks use securitisation: not only do they get their capital back to recycle but they also get the excess interest as a profit stream.

However, they can only receive the excess interest if all RMBS investors have been paid all that is due to them. This excess interest is a powerful third investor protection and aligns the interest of the bank with the bondholders.

4. Originator takes first loss position

For non-banks, the originator of the loans in the RMBS is required to retain the most junior bond in the RMBS structure. In this way, if there are any losses not covered by the first three investor protections, then these are first allocated to the originator's holding in the first loss position. This aligns the originators interest in the loans with those of the RMBS investors and is the fourth investor protection.

House prices are important for the 'wealth effect' and government coffers but they have a second order impact on borrowers' capacity to pay their mortgage. An IMF stress test of the major banks concluded unemployment is the most important driver of the performance of home loans.

No payment shock and the impact of rising rates on borrowers

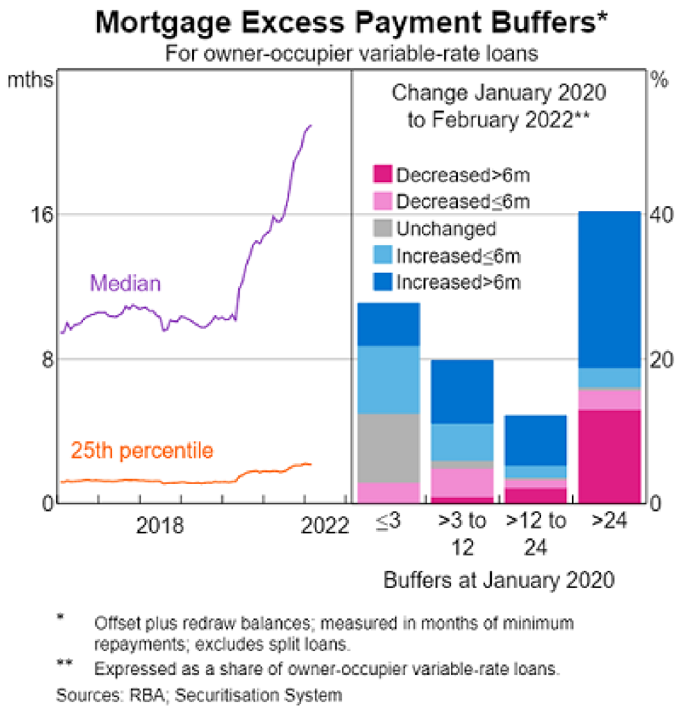
Gryphon's analysis on the impact of variable mortgage rates increasing by 2% is consistent with the RBA's conclusion that:

'… the majority of indebted households are well placed to manage higher minimum loan repayments …'

Stress testing is focused on the borrowers facing the largest increase in their minimum loan repayments and who, therefore, are the most vulnerable to rate rises. For this cohort of borrowers, a combination of serviceability buffers, elevated savings rate, over-payment history and strong employment growth provides effective mitigants against financial stress. Additionally, the substantial build up in borrowers' equity will also enable any borrowers experiencing financial pressure to voluntarily self-manage their way out of arrears through property sales.

Specialist asset class

Historically this asset class was reserved for institutional investors and requires a selective management approach. Not all RMBS are the same and it takes a dedicated team of specialists to select only the best risk adjusted returns and strongest capital preservation. This requires data collection, processing and stress testing capabilities to support rigorous risk analysis systems. It is not the realm of the generalist fixed income manager who must rely on external rating agencies to guide them. In our case we use in-depth analysis and stress testing to find those bonds with the highest risk adjusted returns that still provide strong capital preservation.



Conclusion

RMBS are structured to protect investors from the kind of environment we are in today. They have four levels of investor protection that provide strong capital preservation. According to Standard & Poor's, no investor in Australian RMBS has suffered a loss when holding to maturity.

A well selected RMBS portfolio will provide investors with regular and reliable income with strong capital preservation and protection from rising rates and inflation.

Ashley Burtenshaw is co-founder and Chief Investment Officer at Gryphon Capital Investments. Gryphon is a fixed income manager specialising in residential mortgage-backed securities (RMBS). Gryphon uses a unique quantitative-based and research-based investment process that improves reliability and consistency of returns. *www.gcapinvest.com/our-lit/*