Firstlinks
a Morningstar company

Edition 491, 13 January 2023

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Editorial

Wealth equals income minus ego.

Our ego is part of who we are, though too much of it can hurt decision-making and destroy wealth. Here are three short stories about how ego can affect decision-making, and some tips on how to tame overconfidence to become a better investor.

1. Shooting for the moon

It's 1958 and America's still reeling from the Soviet launch of Sputnik 1, the world's first artificial satellite. Since the end of World War Two, the US and Soviet Union had been locked in a tit-for-tat nuclear arms race. Sputnik 1 signalled that it had evolved into a space race too.

The US feared it was falling behind the technology of its archrival. The question was: what could it do to boost flagging morale at home and, at the same time, show its military superiority to the Soviets and the world?

Enter Project A119. The US Air Force approved the top-secret project, named 'A Study of Lunar Research Flights'. It was led by leading physicist, Leonard Reiffel, who would go on to become Deputy Director of NASA's Apollo space program.

The Air Force asked Reiffel to fast-track the project to examine the visibility and effects of a possible nuclear explosion on the surface of the moon. Reiffel knew early on that the project wasn't about technology but politics. He said later:

"It was clear the main aim of the proposed detonation was a PR exercise and a show of one-upmanship. The Air Force wanted a mushroom cloud so large it would be visible on earth."

Reiffel headed a ten-man team which included a young Carl Sagan, an astronomer who went on to become an author and celebrity, and Gerard Kuiper, the man now considered the 'father of modern planetary science'.

It's never been revealed how the nuclear device would have reached the moon, but Reiffel claimed it was technically feasible to hit the moon with an accuracy of within 3.2 kilometres. It's likely that the mission would have included an intercontinental ballistic missile and the nuclear device would have been an atomic bomb.

Despite his scepticism, Reiffel – in a 1959 report - said Project A119 could achieve several things:

"It is quite clear that certain military objectives would be served since information would be supplied concerning the environment of space, concerning detection of nuclear device testing in space and concerning the capability of nuclear weapons for space warfare."

Though the report went on to state that while the blast would be relatively small, it could come at a huge cost of contaminating the moon with radioactive material, and 'if such biological contamination of the moon occurred, it would represent an unparalleled scientific disaster, eliminating several possibly very fruitful approaches to such problems as the early history of the solar system, the chemical composition of matter in the remote past, the origin of life on earth, and the possibility of extraterrestrial life.'

That killed off the project.

News of the nuclear plans only came to light in the late 1990s. It was revealed then that the Soviet Union had a similar plan to the US at that time and it also got canned.

Thank goodness ego didn't win out in this instance, though it nearly did again four years later when the two Cold War combatants came perilously close to starting a nuclear war during the Cuban Missile Crisis.

2. Betting big

In 1982, Jim Paul had it all. He was a star futures trader who served on the board of governors at the Chicago Mercantile Exchange. He made loads of money, travelled frequently, and was considered among the best at his craft. His confidence and money-making skills knew no bounds.

Then he had a trade which seemed like a sure thing. The soybean oil market was exceedingly tight as limited supply met still buoyant demand. Paul was sure that soybean prices were about to jump.

And he bet big on his convictions - his futures trades exceeded the limits on positions set by the Chicago Board of Trade. He even borrowed US$400,000 from friends to increase his personal position in the trade.

When soybean prices started falling, Paul's confidence didn't waver. While his clients and other traders abandoned the trade, he held on. He ended up not only losing clients' money, but $1.6 million of his own, including that borrowed from friends. And, unsurprisingly, he lost his job.

He later wrote a book about it called *What I Learned Losing a Million Dollars*.

3. A personal story

To a personal story. I was once a relatively new equities portfolio manager, and I went on an offsite meeting with my team to discuss strategies for the year ahead. We had several new team members and our boss asked each of us what our goals were for the fund. I was up first and answered, 'I'm a competitive guy and want our fund to be among the best. I don't want us to be like your typical benchmark-hugging fund'.

I don't recall many of the answers that followed except one from a senior team member, who said, 'I want us to sustainably grow our clients' wealth so they can help their families and possibly fund their retirements'.

At that moment, I realized how lame my answer had been.

It was more than that. I reflected on how I'd let my ego affect other decisions I'd made as a portfolio manager. A few weeks earlier, I got the investment fund into a stock which had fallen hard but where I felt business fundamentals would soon improve. I'd put our fund into a big, contrarian bet.

At the team meeting, I saw that I'd taken this large position to prove myself to the team and others.

Put simply, it was an ego trip that put client money at risk.

How to park your ego

These stories show how ego can affect decision-making in all sorts of ways.

Life might be easier if we could just get rid of ego, yet that isn't possible. It's part of our identity. Ego gives us confidence in our abilities and judgments. Science suggests that confident people are more likely to be resilient and find professional success. And ego also protects us from the opinions and judgments of others.

Taken too far though and ego can cause long-lasting damage. In investing, too much self-confidence can destroy wealth, as it did with Jim Paul.

What can be done to tame the ego? I like Aristotle's analogy of a warped piece of wood to describe human nature. To eliminate warping or curvature, a skilled woodworker slowly applies pressure in the opposite direction - essentially, bending it straight.

Here are four tips to help straighten your ego:

1. Turn down the competitive streak

We are trained to compete and win contests. From standardised testing at primary school through to sports and getting jobs. Competition is about beating others and boosting your self-esteem. Done in moderation, it can be a good thing; taken too far, it can do harm.

In investing, too much focus on making more money than your neighbour will impact your decision making and returns.

2. Detach your ego from the outcome

In markets, gains and losses can be taken personally, as a reflection of your self-worth. That's the ego at work. But being right and making a profit aren't necessarily the same thing. And being wrong and taking a loss aren't the same either.

Jim Paul addresses this in his book:

"Personalizing successes sets people up for disastrous failure. They begin to treat the successes totally as a personal reflection of their abilities rather than the result of capitalizing on a good opportunity, being at the right place at the right time, or even being just plain lucky. They think their mere involvement in an undertaking guarantees success. This phenomenon has been called many things: hubris, overconfidence, arrogance. But the way in which successes become personalized and the processes that precipitate the subsequent failure have never been clearly spelled out."

3. Add a dose of humility

We can all heed the example of William Tecumseh Sherman, who rose from nothing to become a great general during the American Civil War, but repeatedly turned down higher military titles, and promoted the successes of others for the good of his country. A biographer said of him:

"Among men who rise to fame and leadership two types are recognizable-those who are born with a belief in themselves and those in whom it is a slow growth dependent on actual achievement. To men of the last type their own success is a constant surprise, and its fruits the more delicious, yet to be tested cautiously with a haunting sense of doubt whether it is not all a dream. In that doubt lies true modesty, not the sham of insincere self-depreciation but the modesty of "moderation," in the Greek sense. It is poise, not pose."

Poise over pose; humility over the ego.

4. Diversify your investments

Concentrated portfolios reflect self-confidence, or ego. In expert hands, they can work. In mere mortals, they can be a disaster. Having a diversified portfolio is the best way to keep your ego in check.

In this week's edition ...

Matt Reynolds of Capital Group says investors should look beyond high yielding stocks to include dividend growers – stocks that pay and consistently grow a dividend. He believes these stocks will more sustainably increase dividends and generate real long-term returns.

Magellan Financial Group has been in the wars, though **Andrew Brown** of East 72 sniffs an opportunity. He sees deep value in the stock and thinks the impact of institutional fund outflows has been overplayed. Brown also raises the intriguing possibility of Magellan teaming up with Barrenjoey to build an investment banking 'powerhouse'.

John Abernethy is licking his lips after the market fall. He says economic growth, profit growth and therefore dividend growth in Australia is fairly assured over the next decade and the chance for patient investors to benefit is enhanced by the recent correction.

It's great to welcome one of Australia's best international investors, **Willy Packer**, to *Firstlinks*. Packer's fund has had only three negative returning years since inception 28 years ago (and was positive in 2022). He also predicted the 2000 tech crash, the 2008 GFC and the popping of last year's 'everything bubble'. Today, Packer remains cautious, though sees bright prospects for nuclear energy, oil and cheap China plays.

GQG Partners were one of the few international investors to pivot away from tech stocks before last year's crash. The research team sees more downside for software companies, drawing on lessons from shale oil's boom and bust in 2014-2016. It suggests software and shale oil represent excesses of the last decade driven by easy capital, as well as the dangers of ignoring capital cycles.

Stephen Miller of GSFM is concerned that the RBA and interest rate markets are underestimating inflationary pressures. Combined with a government intent on increasing wages, there's a risk of entrenching higher inflation in Australia compared to elsewhere.

And **Peter Zeihan** is back with a unique take on the rise of electric vehicles. Zeihan predicts they're not going to be a large part of our transport future for at least the next decade, probably closer to three decades.

In this week's white paper, **Cromwell Funds Management** looks at how hybrid work and ESG will transform the office property market.

Graham Hand is back from sabbatical leave next week. Thank you for putting up with me while Graham has been away. I'll continue to help edit *Firstlinks* and contribute articles.

James Gruber

Buying dividend growth over dividend yield

Matt Reynolds

For global equity investors, investing in growth strategies proved a wise move over the past decade, particularly with the stellar performance of many technology companies. Unsurprisingly, global growth strategies have largely overshadowed global dividend strategies.

However, the macroeconomic forces that drove these stellar equity returns are being upended. Inflation continues to reach multi-decade highs and has become more widespread than many economists ever imagined.

We are moving into a new environment – from deflation to inflation, quantitative easing to quantitative tightening, globalisation to de-globalisation, and affordability to cost of living crisis – and against that backdrop, we have seen equity market leadership change and valuations compress. Consequently, the traditional growth/value divide feels less relevant today.

With global economic growth expected to slow significantly in 2023 and beyond, the path towards policy normalisation could still mean further interest rate rises. This has given way to rising volatility and reduced earnings growth visibility, putting strain on widely held growth strategies.

As investors contemplate which equity strategies might prevail, finding a complement to growth strategies will be key to achieving long-term investment objectives – even if growth comes back. Such solutions will require resilience in uncertain markets, an ability to select from a broad range of sectors, and long-term real return generation.

The road to resilience begins with dividends

Conventional wisdom suggests that value stocks and dividend payers appear well-suited to the current environment, given their heavy reliance on dividend reinvestment for return generation.

Dividends have typically been the more stable component of equity returns over the years, relative to earnings growth and multiple expansion, comparable to the fabled tortoise against the hare.

There is evidence of dividends' steady but meaningful return profile throughout the last century; the average contribution to 10-year returns has been 40%[1], (although this decreased in recent decades as companies prioritised putting capital back into businesses and share buybacks over returning it to shareholders). Furthermore, except for the 1970s, dividend reinvestment has consistently kept pace with inflation.[2]

Dividends' resilience are apparent in stressed markets as dividend payments have shown themselves to be less susceptible to deep cuts than earnings growth.[3]

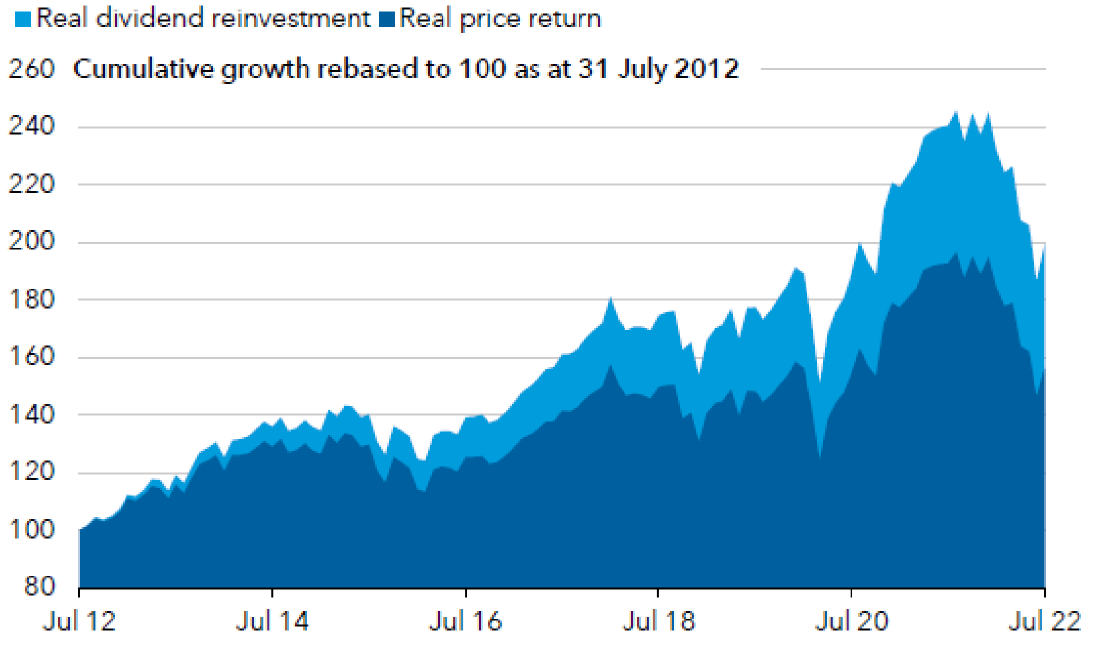
Dividend-focused strategies can complement growth-focused strategies

Past results are not a guarantee of future results.
MSCI AC indices returns from 31 July 2012 to 31 July 2022, shown in US$ and with net dividends reinvested. P/E: price to earnings.
Sources: Refinitiv, Capital Group

Dividend growers: a strategy for all seasons

Dividend investing isn't just for tough markets. It plays a powerful role in the generation of long-term returns, making it a sound strategic fit for investor portfolios.

Dividend investment has been important for long-term real returns



Past results are not a guarantee of future results.
Based on monthly price and total returns for MSCI All Country World from 31 July 2012 to 31 July 2022 in US$. Real returns are nominal returns adjusted for inflation based on US CPI All Items. Sources: FactSet, Capital Group

However, unlocking the potential rewards of dividends may require investors to consider investing beyond high yielding stocks to include dividend growers – stocks that pay and consistently grow a dividend.

These companies have historically been a compelling source of portfolio returns because of their risk-return characteristics. And as expectations for weaker economic growth and asset returns set in, dividend growers could become increasingly relevant.

The way we have characterised dividend growers over the years is by identifying companies that have typically been higher quality firms over high yielders, given their strong histories of profit and earnings growth as well as higher returns on assets, equity and invested capital.

Their solid fundamentals have enabled these companies to compound their growing income stream at levels greater than high yielders, rewarding investors with strong gains.

One of the potential benefits of focusing on dividend growth can be avoiding some of the pitfalls that come with high dividend yield investing. These pitfalls include:

Unsustainable dividend policies. A study by Wellington Management indicated that chasing the highest yield is unlikely to deliver the highest returns in the long run. The analysis ran from 1930 to 2021, looking at the behaviour of US stocks sorted by dividend yield. Over that period, the second-highest quintile outperformed the broad index 78% of the time – the highest score relative to all other dividend yield quintiles. The explanation for this was the significantly lower payout ratio. Payout ratios are a measure that help illustrate how sustainable a dividend policy is given its calculation of dividends relative to earnings. According to the study, from 1979 to 2021, the average payout ratio for the second quintile was 41% versus 74% for the top quintile.[4] A very high payout ratio can be indicative of limited growth or the dividend growth prospects of a company. What's worse is that if the company's earnings deteriorate, the dividend could be in jeopardy.

Higher likelihood of cutters. When it comes to dividend investing, one of the biggest threats to returns is a dividend cut. This is often a sign of financial distress. In fact, Ned Davis' 2022 research covering the period 1973 to 2021 shows dividend cutters have endured the worst returns among dividend payers, delivering a loss of 0.5% p.a. with 25% p.a. volatility. In contrast, dividend growers and initiators have delivered a gain of 10.7% p.a. with 16.0% p.a. volatility, proving their strength.[5] Most recently, when dividend payouts fell sharply in 2020 to levels last observed in 2009, dividend cuts were almost 30% higher for high dividend yielding stocks in 2019 and 2020, according to S&P's research on US stocks. This implies dividend growers could be less vulnerable to cuts.

Niche universe of dividend payers. High yielders have historically been confined to a narrow subset of stocks. Consequently, investors who focus only on high yield limit their investment opportunity set to a niche part of the market. Another area where investment risk is less balanced is equity factors, given the MSCI World High Dividend Yield index's significantly higher exposure to value and large cap.

For investors, ongoing macroeconomic uncertainty and volatile markets continue to divide many on future equity leadership. But regardless of whether growth stocks return, or value stocks persist, we believe current conditions present an opportunity to build resilience through dedicated dividend strategies.

Even when economic conditions improve, we believe that dividends deserve to stay in a portfolio. By adopting a fundamental approach to identifying companies that can consistently pay and grow their dividends, investors can achieve long-term real return generation through the investment cycle.

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

For more articles and papers from Capital Group, click here.

[1] Based on S&P 500 total returns in US$ from 1930 to 2021. Source: Ned Davis Research
[2] Based on returns from 31 January 1938 to 28 February 2022 in US$ for S&P 500. Sources: Capital Group, Standard & Poor's, Robert Shiller, Morningstar Direct, FactSet
[3] Based on MSCI World dividends-per-share and earnings-per-share drawdowns in US$. Sources: FactSet, Capital Group
[4] Based on research by Wellington Management, 2022.
[5] Based on US$ returns of S&P 500 stocks sorted by dividend policies from 1973 to 2021. Source: Ned Davis Research, 2022

A contrarian bet on Magellan Financial Group

Andrew Brown

This piece stands back and looks at longer term valuation, which can go from absurd optimism to “they’re dead” valuations.

How absurd did Magellan get at the peak?

At $74.90, Magellan shares were priced by investors at $13.65 billion. So at peak crazy, Magellan (MFG) was priced at 12.7% of funds under management (FUM) and 38.4x P/E of annualised net profit before performance fees. This at a time other listed global funds managers were priced at ~10x P/E and fractions of the FUM percentage.

Not at the peak, but part-way there, at a price of $55.20/share in August 2019, MFG placed $275 million of shares with the rationale being to fund a new retirement product (since dumped) and costs associated with a new trust and other “balance sheet strengthening” purposes.

However, in our view, the placement has eventually been put to excellent use.

Principal investments

One of the clear indicators to MFG outsiders that objectives other than running a top-class global funds manager had entered the equation emerged in September 2020, when MFG made the first of three significant external principal investments in three months. The least logical has been sold with a very good return, and the other two are an excellent fit.

In December 2020, MFG acquired what eventually turned into 11.6% of Guzman y Gomez, a fast food chain. The eventual investment of $102.7 million was turned into $140 million (before costs) in 17 months. Bluntly, this appeared to be a hubristic investment, irrespective of its financial success.

In September 2020, MFG acquired a 40% economic interest in Barrenjoey Capital Partners Group Holdings (Barrenjoey), at a cost of $156 million.

MFG have numerous personal linkages with Barrenjoey, mainly from the coterie of highly talented ex-UBS personnel who formed the new business. These folks know each other and their skills. From a standing start, Barrenjoey had 348 employees by 30 June 2022.

Barrenjoey’s accounts break the company into 'established business' – corporate advisory, equity capital markets and cash equities/research. That business generated $227 million in revenue in the latest year and an operating profit of $57 million – before IT establishment expenses – and $44 million of IT is expensed, not capitalised.

Based on compensation expenses in the FY2022 year, the business is built for revenues of well over $300 million even in mundane markets, using US peer group comparisons. That should categorically take the business to profitability. Moreover, with some global brokers pulling away from equity financing (prime broking) – notably Credit Suisse – and others constrained by global parents, Barrenjoey should be able to find a real niche, since many of the personnel operated within a highly decentralised UBS Australia, which had 'special dispensation' from Zurich. Because they made so much money.

MFG carries the Barrenjoey investment using equity accounting at $133 million in the accounts – below the cost of their $156 million commitment. It might be accounting standards but makes no sense. Based on the total Barclays investment ($120 million for 1,819 preference shares), MFG’s investment could notionally be valued at $264 million, valuing Barrenjoey at $725 million based on economic interest or 4.5x book value. Is it unrealistic to envisage Barrenjoey earning (say) $70 million p.a. in two years from a far greater range of activities? We think not.

Magellan invested $20 million for ~17% of Finclear in November 2020. Finclear was founded in 2015 and has grown organically but also by two significant acquisitions, notably that of the largest clearing broker in Australia, Pershing Securities in 2021. Finclear executes, clears, and settles between 15 and 50% of all retail transactions that go through the Australian ASX on any given day.

Given the difficulties being experienced by the monopoly clearing agency in Australia (ASX) in replacing its main holding system (CHESS) we see Finclear as having intriguing opportunities over the medium term and a highly complementary investment to that of Barrenjoey for Magellan.

Conservatively, 45% of Magellan's market capitalisation is investments

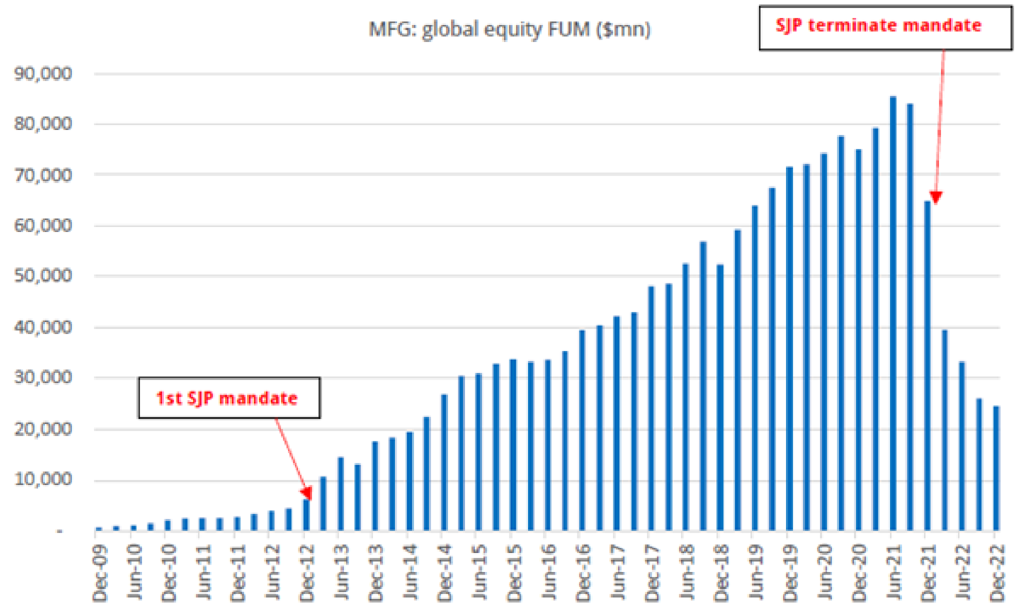
We estimate MFG to be holding over $4/share in cash, seed and other investments as follows:

	$million	Comments – adjustments from 30/6/22
Cash (E)	326	y/end $420m less dividend ($125m) less buyback ($39m) + earnings (~>$70m)
Option liability	(133)	Liability to cover 7.5% discount on option exercise of MGF LIC (expires March 2024) – see later
Working capital	-	Receivables less employee liabilities & creditors and tax
Cash net of option liability	**193**	**$1.06/share**
Seed investments unit trusts	379	$2.09/share
Barrenjoey (at book)	133	$0.73/share (potentially up to $1.45/share)
Finclear (at book)	29	$0.16/share
TOTAL INVESTMENTS/CASH	**734**	**$4.04/share**

All growing funds managers seed new vehicles, the larger ones in larger ways. But the massive decline in MFG's equity capitalisation, along with the Guzman y Gomez investment sale and some innate conservatism, has left MFG with cash estimated at >$1.00/share, seed investments in MFG funds of over $2.00 a share and the two (in our opinion) really smart "market plumbing" investments, on the books (combined) at $0.90/share, but in our view worth much more. All up, on our estimates, ~$4.04/share or $737 million against an equity capitalisation below $1.6 billion.

On that basis, at current prices of $8.94/share, MFG's three funds management businesses are priced by the equity market at a maximum $4.90/share or $889 million, or 1.77% of FUM. Is this realistic?

Magellan FUM and a rough valuation



We estimate MFG now has global equity institutional funds (excluding infrastructure) of below $7 billion. All but ~$400 million of Airlie's $8.5 billion of FUM is institutional. The rapid decline of MFG institutional funds shows the domino like effect of this type of money.

Airlie, an exclusively Australian equity manager, was acquired in March 2018 for $97.1 million – exclusively in MFG shares. The acquisition price was consistent with our metrics for institutional managers at 1.61% of FUM. Airlie's performance has been excellent over a three-year period, and FUM has grown to $8.5 billion, including $400 million in the retail fund.

Performance (30 November 2022)	3 mths	6 mths	1 year	3 years (% pa)	Since inception (% pa)
Airlie Australian Share Fund	6.12%	5.92%	1.33%	10.45%	10.94%
Benchmark	6.04%	3.51%	5.00%	5.93%	8.48%
Excess Return	0.08%	2.41%	-3.67%	4.52%	2.46%

Based on interpolating the same metric to current FUM, despite the 5% FUM retail component, implies a value of ~$137 million for Airlie. Hence, the guts of MFG's valuation has to be the price applied to the 'retail' global equity business. We estimate MFG has just over $14 billion of retail global equity FUM, of which $2.7 billion is contained within the closed-end version of the Magellan Global Fund (ASX: MGF). This fund will struggle to raise new equity even via option exercise.

We estimate using simple industry metrics that MFG's fund management stream can be valued at just under $1 billion:

Global equities – institutional	65	6,500 @ 1% FUM
Global equities – retail	345	11,500 @ 3% FUM
Global equities – closed end	108	2,700 @ 4% FUM
Infrastructure – blended	324	16,200 @ 2% FUM
Airlie - blended	137	Per above acquisition metric
FUNDS MANAGEMENT STREAM	**979**	**$5.40/share**

This fund management valuation can be cross-checked very simply against MFG's consolidated operating metrics. MFG's consolidated revenue from funds management averages a base management fee of ~62bps; on the current level of FUM ($45.3 billion) this equates to annual revenue of $281 million (average FUM of $53.8 billion and hence annualised revenue in H1 FY2023 will be above this). In recent presentations, MFG have reiterated funds management business operating expenses of $125-130 million.

Hence, at the $45.3 billion level of FUM, MFG's funds management business should produce pre-tax "cash" profit of ~$151 million, or $106 million after notional tax, excluding performance fees. Our valuation cross check therefore equates to 9.2x notionally fully taxed funds management profit at current FUM. That is in the lower echelon of the cohort group.

Magellan's core fund performance appears to be levelling off, but not yet significantly improving – that takes time. The clear hole left by the ill-fated Chinese-tech play can be seen in the 3-year per annum numbers, below:

Performance (30 November 2022)	3 mths	6 mths	1 year	3 years (% pa)	5 years (% pa)	7 years (% pa)	10 years (% pa)	Since inception (% pa)**
Magellan Global Fund (Open Class) (Managed Fund) (ASX:MGOC)	5.70%	5.08%	-7.77%	1.87%	8.03%	8.25%	13.40%	10.44%
Benchmark*	6.44%	5.21%	-5.62%	7.88%	10.08%	10.15%	14.50%	7.17%
Out/Under Performance	-0.74%	-0.13%	-2.15%	-6.01%	-2.05%	-1.90%	-1.10%	3.27%

* MSCI World Net Total Return Index (AUD)
** Inception date 01 July 2007

Magellan valuation and concluding thesis

We conservatively value MFG at $9.44/share based on 31 December 2022 FUM; being more liberal, we see scope to lift this to just under $11/share based on eliminating the option exercise liability and revaluing the Barrenjoey investment to reflect the entry price of Barclays:

	base	uplift
Investments/cash per table	734	734
Uplift Barrenjoey	-	131
Eliminate option liability	-	133
Funds management stream per table (9.2x P/E; 2.16% FUM)	979	979
TOTAL VALUATION	1,713	1,977
Per share (181.5million)	**$9.44**	**$10.89**

Whilst the 31 December 2022 MFG share price is only marginally below our base valuation, we see multiple areas of optionality for MFG to add shareholder value. Our valuations offer nothing for the capacity to generate performance fees, nor the inherent beta to equity markets – which we acknowledge may take time to play out.

However, we suspect equity markets are moving to a dynamic where stock picking rather than index-beta – which MFG have used to advantage in the past – will be a more important determinant of fund performance relative to benchmark. This does suggest Magellan have an above average chance of improvement (as do Platinum) and thereby start to redeem their reputation. The chance of new institutional mandates is virtually nil in the next three years, but the slowing of retail redemption is far more important.

And what about those investment banking skills?

Is it beyond the realms of possibility that Magellan may get together with Barrenjoey to build a FULL investment banking "powerhouse" with funds management, broking, M&A/ECM, stock lending and a strong capital base to boot? Given that the investments and funds management businesses of MFG make up roughly 50/50 of the current valuation, a separation and merger of Barrenjoey is hardly rocket science for smart bankers with a clear motivation. As we know from the extravagant rating of Macquarie (MQG) Australian investors would likely relish the thought. That clearly is an option not priced into MFG at current levels.

Hence, we have built a moderate portfolio position, with scope to add further if (very) sloppy equity markets derail FUM, which we see as the main risk to the position.

Andrew Brown is Executive Chairman of [East 72](), a leveraged investment company operating through its subsidiary entity, East 72 Investments. This article contains general information only; it does not purport to provide recommendations or advice or opinions in relation to specific investments or securities. It has been prepared without taking account of any person's objectives, financial situation or needs and because of that, any person should take relevant advice before acting on the commentary.

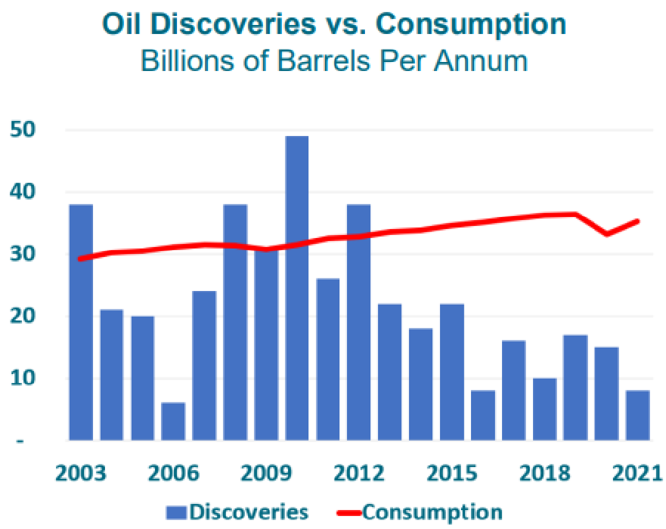
This article has been extracted from East 72's [Quarterly Report #26]().

The bull case for nuclear energy, oil and cheap China plays

Willy Packer

The biggest crisis facing the world economy is a lack of cheap energy to drive economic prosperity and growth. Three quarters of the world's energy comes from fossil fuels, but underinvestment in exploration over the past decade has resulted in the world consuming three times more oil than was discovered.

The west is now highly dependent on OPEC and Russia for its oil supplies making it exceptionally vulnerable. Spare capacity is minimal, and the US and Europe have drained their emergency reserves to hold oil prices down, lulling people into a false sense of security. China's lockdowns have tempered oil demand but recent moves to reopen will add further pressure to the global oil market.



The great energy transition to wind and solar power has so far had very little impact on demand for fossil fuels. What is scary is that governments continue to endorse the renewables transition despite having no clear plan as to how their intermittency will be addressed. Enormous batteries are still way too costly, so expensive back-up generation is required, resulting in rising energy costs for consumers.

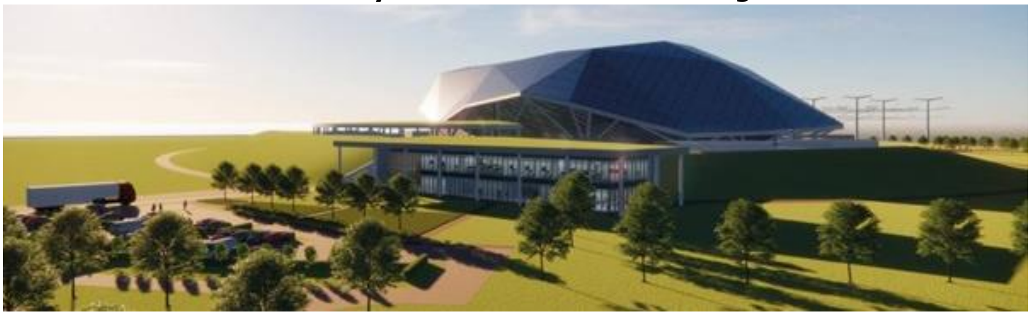
The CEO of Origin Energy recently called for "honesty" with the Australian public about the increase in electricity bills required to finance the "truly staggering" investment necessary to meet Australia's 2030 emissions target.

What can be done?

From what we can see, the only realistic way to provide clean, affordable, and reliable energy to the world's growing population is to go nuclear. Europe is finally waking up to this with the UK, France, Poland, Netherlands, and Belgium restarting their nuclear programs.

Companies such as Rolls Royce are developing new cost-effective small modular nuclear reactors that can be built in factories and transported on trucks whilst incorporating fourth generation safety features.

Rolls Royce - Modular Reactor Design



However, building nuclear generation will take a long time. In the meantime, we have a growing world population that aspires to improved standards of living. Oil, gas, and coal will therefore be with us for some time to come.

Easy money and inflation

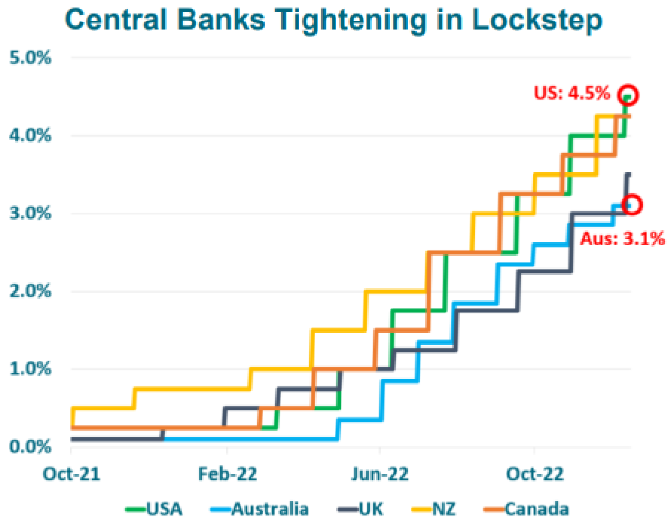
The energy crisis is reinforcing the inflation nightmare the world faces. As we all know the inflation genie is out of the bottle and interest rates are rising faster than at any time in recent history. Central bankers were slow to react in 2021 deeming inflation 'transitory' and face an uphill battle to regain credibility. They are now marching in lockstep to rein in the inflationary beast.

In the wake of COVID, the lowest interest rates in history fostered a speculative boom bigger than any other, with people betting on nearly anything that walks or crawls.

The crypto craze was symptomatic of the boom, with investors buying 'assets' that pay no interest or dividend, are far from secure, chew up valuable energy and have endless competitors as promoters conjure up new coins and sell them to the unsuspecting public.

Similarly, profitless tech stocks have been punished. The destruction is highlighted by the 80% collapse in the share price of the high-profile ARK Innovation Fund. ARK soared in 2020 and 2021 as risky technology stocks took off, the majority of which have now sunk.

These are the canaries in the coal mine. Throughout history, reckless risk taking has always led to disaster.



Governments seem ill-equipped for challenges

Governments and central banks seem ill equipped to handle the plethora of economic problems the world faces.

Firstlinks
a Morningstar company

Modern monetary theory which professed that printing money, known as quantitative easing, could solve our problems has now been completely discredited. Markets are ultimately bigger than any government, proven by George Soros breaking the British pound. More recently, Liz Truss met her Waterloo when her proposal to cut taxes and run huge deficits led to soaring interest rates and the pound collapsing once again.

Philip Lowe, the Governor of the Reserve Bank of Australia, is one of the world's first central bankers to admit to all the problems. Dr Lowe recently warned that de-globalisation, fewer working-age people, rising barriers to trade and the revival of the trade union movement will affect both living standards and price levels. Additionally, he highlighted that the renewable energy transition was leading to insufficient investment in traditional energy sources, resulting in "higher and more volatile energy prices".

The boom in asset prices over the past decade will be hard to repeat considering the headwinds economies and markets confront.

Governments will be keen to tax anything that moves. The British and German governments have already started upping taxes on oil, gas and renewable producers and the Australian Federal and Queensland governments are following suit.

With budget deficits worsening, tax departments have their sights set on multinationals, but there will be pressure for taxes to rise across the board. As we commented earlier the outlook is inflationary, however this could swing deflationary at the drop of a hat if further interest rate hikes cause a crash in stocks, bonds, and property, similar to what happened in 1987.

How our fund is positioned

Given the precarious state of the world economy and unstable asset markets, we are maintaining 12% of the Trust in gold and 39% in Treasury Bills that now yield 4.5%.

We currently have 19% of the fund in non-Russian energy related stocks that are earning huge profits and paying big dividends. We have another 7% in Russian oil and gas stocks that are also making large profits, but foreigners remain unable to trade and hence they are valued at a 48% discount to Moscow Exchange prices. All our energy companies have huge reserves and bright futures in an energy constrained world.

Non-Russian Energy Investments

	Portfolio Weight	P/E	Dividend Yield
CNOOC	8.1%	3.0x	16%
Hess	7.5%	19.7x	1%
New Hope Corp	1.7%	2.6x	26%
Whitehaven Coal	1.2%	2.3x	14%

Our biggest holding is China National Offshore Oil Company (CNOOC), which is one of the world's preeminent oil producers, and is among industry leaders in production growth, profit margins and returns on capital. CNOOC is also incredibly cheap, capitalised at $60 billion, it will produce 500 million barrels of oil this year, generating a profit of around $20 billion.

Further to this, CNOOC owns 25% of the world class Starbroek block in Guyana, with Exxon and Hess. The Starbroek field has a resource of 12 billion barrels of oil, with analysts predicting it to eventually surpass 20 billion barrels. Production is aggressively ramping up over the coming decade.

Hess also remains excellent value thanks to its 30% interest in Starbroek and its significant US shale oil assets, which generate huge amounts of cash at current oil prices. Hess's interest in the "discovery of the decade" makes it a prime takeover target.

Our non-energy investments are all in resilient industries and have sound balance sheets, so can hold their own when things get tough. Further, they are priced attractively.

We recently acquired shares in Alibaba, China's leading ecommerce business after its share price fell 70% from its 2020 peak. Revenues and profits are growing soundly, and it trades on a price to earnings multiple of just 12x. Importantly, Alibaba's core ecommerce business is hugely profitable, in stark

Non-Energy Investments

	Portfolio Weight	P/E	Dividend Yield
Bayer	5.1%	6.3x	4.5%
China Mobile	4.9%	7.8x	8.2%
China Unicom	2.9%	8.4x	6.0%
Scorpio Tankers	1.9%	4.5x	0.7%
Alibaba	1.2%	12.5x	0.1%
CGN Power	0.9%	8.0x	5.5%

contrast to its major competitor Amazon which loses money on ecommerce sales.

The only non-profitable stocks we hold are Energy Resources of Australia (ERA) and Berkeley Energia, which both hold massive undeveloped uranium deposits.

Given the revival of nuclear energy, the outlook for uranium demand is positive. The problem however is that many of the world's major uranium mines were developed long ago and are now in decline. Moreover, a substantial portion of supply comes from former Soviet states and potentially unstable African countries, making western utilities keen to source supplies from aligned countries.

Globally there are very few high-quality undeveloped uranium deposits. Arguably the best is ERA's 300-million-pound Jabiluka deposit, discovered in 1971, prior to the formation of the adjacent Kakadu National Park. The Trust has an 8% shareholding in this incredible deposit with Rio Tinto the major shareholder.

Uranium mining has had a contentious history in Australia, and for various reasons the Jabiluka mine has never been developed. A key issue has been opposition from traditional owners; however, opinions can change.

Public perception towards nuclear energy is changing rapidly as the world recognises the need to decarbonise. A deposit of Jabiluka's size, which can be mined with underground machinery and minimal surface impact, would provide enough clean energy to power Australia for at least 20 years.

At the current uranium price, Jabiluka's life of mine revenue would be about $25 billion. If developed, the wealth and jobs created by this project would be enormous for both its traditional owners and for Australia. It would play a genuinely important role in the world's carbon reduction efforts, and it could significantly enhance Australia's relationships with its key security partners.

Willy Packer is the Founder, Managing Director, and an investment manager at Packer & Co. This article contains general information only and does not consider the circumstances of any investor. Please seek financial advice before acting on any investment as market circumstances can change.

This article has been extracted from Packer & Co's Investigator Trust Report.

Ignore the noise, long-term investors will be well rewarded

John Abernethy

One conclusion drawn by analysts, projecting into the future, is that growth will slow, and investment returns will be lower. That cannot be said of the medium to long term outlook for Australia - and probably most of developing Asia. We have abundant tradable resources and outputs across energy and agriculture. We are close to the fastest growing economy in the world and our population will increase by at least 15% over the next decade.

We have abundant capital ($3.5 trillion of super) and a franking system that enhances returns. Our government is not highly indebted, and our budget outcomes are also superior to our peers. Economic growth, profit growth and therefore dividend growth is fairly assured over the next decade and the opportunity for patient investors to benefit is greatly enhanced by recent price corrections.

A focus on the long term is important and there is no rush to invest. Steady accumulation that allows compounding of returns to occur is the key to investment success. Dividend paying companies with quality attributes are the best opportunity.

The challenges

The following are the short-term influences on Australia's prospects:

1. Slower world growth in 2023 than normal, but with no worldwide recession
2. Interest rates to continue to rise but the rate of increase to slow
3. Inflation to peak in coming months and then pull back below 4%
4. Cost of living pressures emerging with higher energy costs
5. Population growth to occur as borders are reopened, and

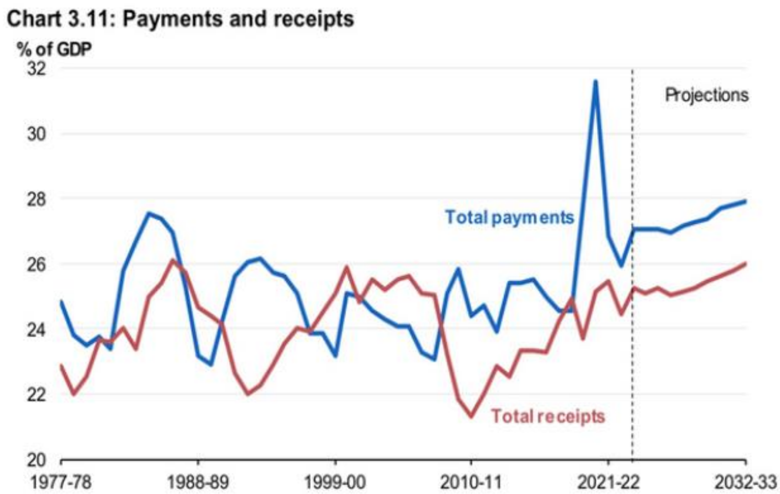
6. China to recover its growth momentum and, together with India, ensuring that our external sector is well supported

It is Australia's position inside the Asian trade bloc that ensures we are well positioned for superior economic growth compared to our developed world peers. In particular, our outlook is far superior to much of Europe.

However, there are short-term challenges, and I will outline these in the following charts.

First, economic growth will slow as the government pulls back on the budget deficit (stimulation) and grapples with a budget structure that has been loaded with social support schemes rather than growth initiatives.

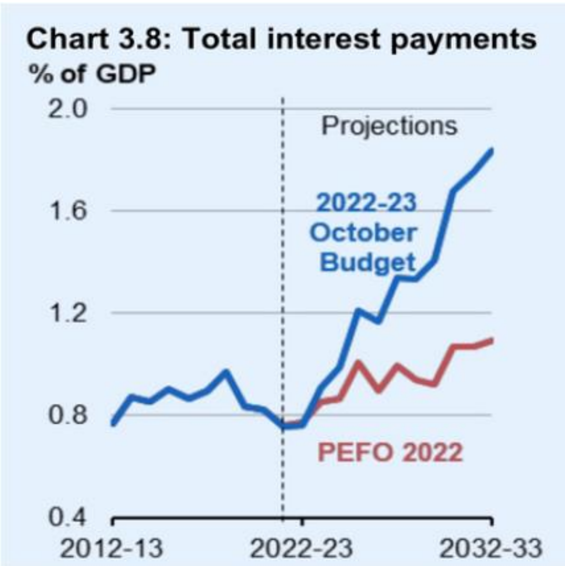
Chart 3.11 shows the budget outlook with the government sector representing a larger portion of economic activity and output than before COVID. The setting of long-term social expenditure programs (e.g. the NDIS and child care) will mean that tax collections as a percentage of GDP must rise.

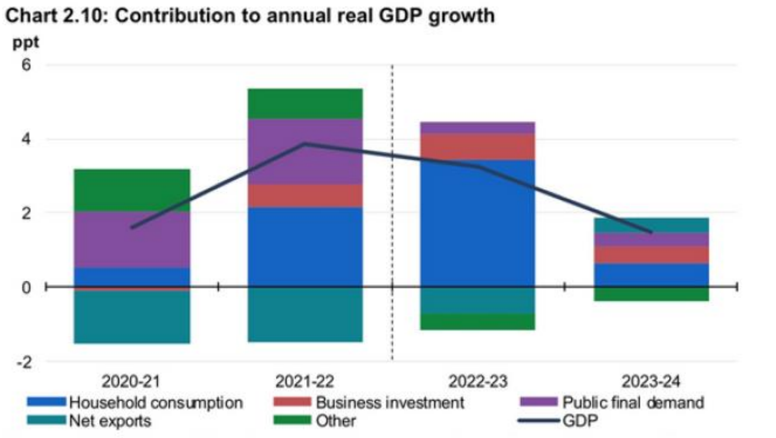


Source: Treasury

Further, the budget outlook is becoming affected by rising government debt (ex-COVID) and rising interest rates on that debt. A further rise in bond yields (above 4%) would impact budget outcomes and affect fiscal policy.

In looking at the household sector, chart 2.10 shows the sector is currently buoyant as it ploughs through the household savings built up during the COVID crisis. The slowdown forecast by Treasury may be conservative, but we must note the concern of government regarding household pressures coming from cost-of-living imposts.





Note: 'Other' here refers to change in inventories, ownership transfer costs, dwelling investment and the statistical discrepancy.

Source: ABS Australian National Accounts: National Income, Expenditure and Product and Treasury

Source: Treasury

Clearly household consumption will slow as interest rates rise because these directly cut into the available discretionary expenditure of mortgage holders.

Chart 2.12: Consumption growth

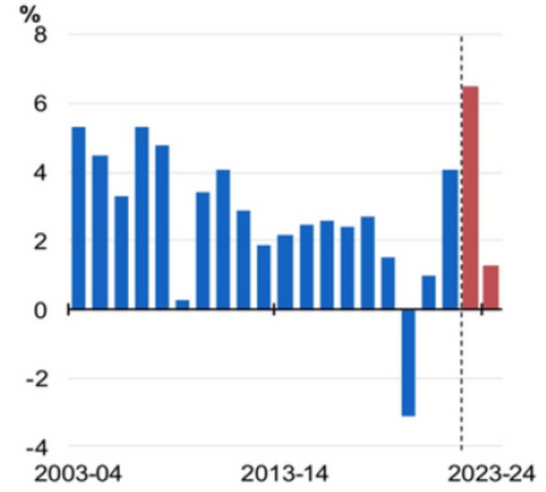
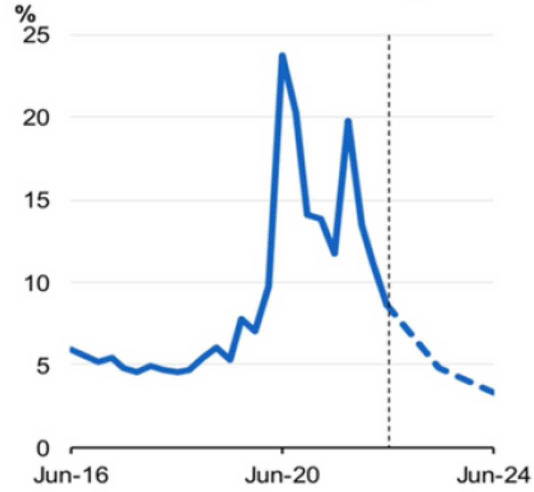


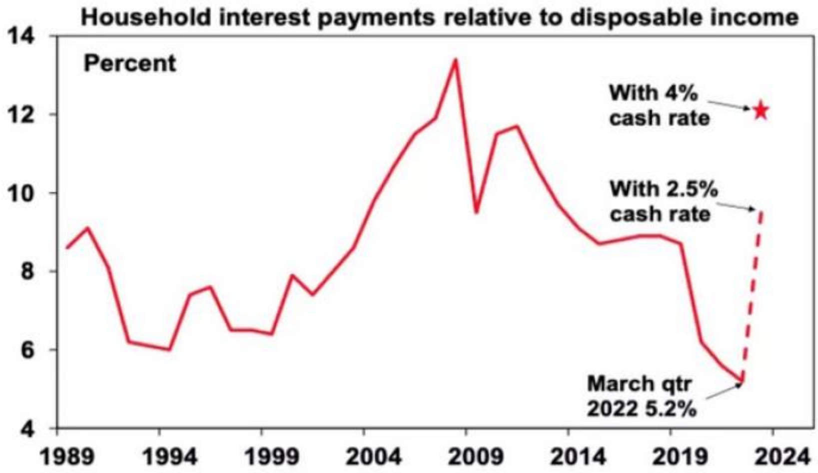
Chart 2.13: Household savings ratio



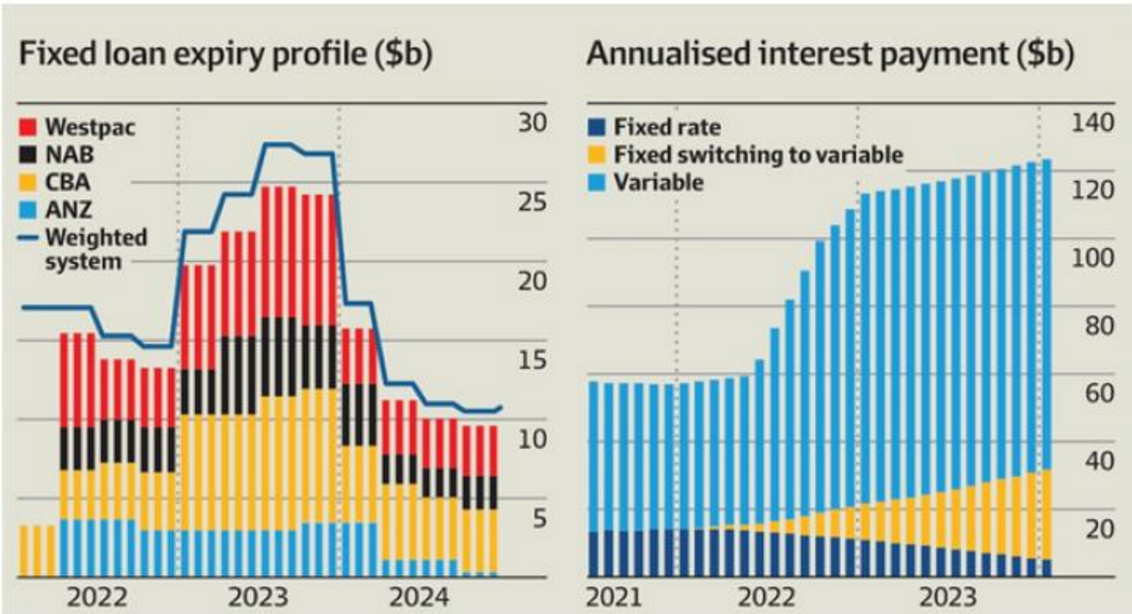
Sources: ABS Australian National Accounts: National Income, Expenditure and Product and Treasury

The effect of rising interest rates on the part of the household sector that is mortgaged is significant. Rising interest rates take from disposable income and discretionary expenditure. Each 1% increase in mortgage rates takes $20 billion from the household sector over one year.

The other looming issue for mortgage borrowers is rolling from low-cost fixed mortgages to variable mortgages. This cycle has commenced with limited consequences (at this point) for banks, but it will need monitoring should it push households into distress in 2023. However, the RBA is aware of this issue and that may result in interest rate increases being checked at some point.



Source: RBA, AMP

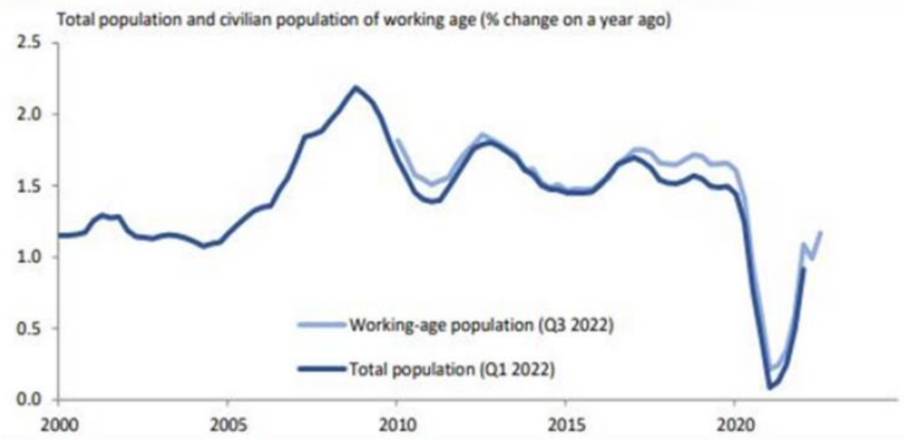


Source: Jarden

The future remains bright

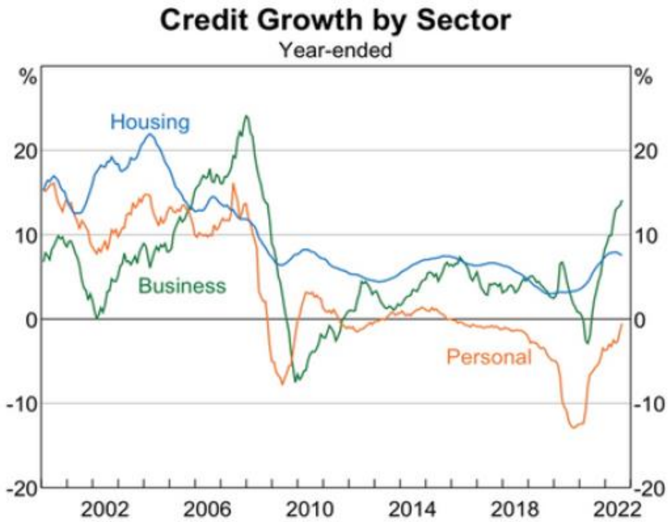
The business sector remains buoyant with capital investment being maintained to meet the growing economy and external trade opportunities. A return of immigration, tourism and overseas student education will bolster Australia's growth and business opportunities.

Figure 1: The population is rebounding strongly after the re-opening of the border



Source: Australian Bureau of Statistics, Coolabah Capital Investments

We can see confidence in the business sector from the steadily increasing business borrowing levels reported by the banking sector to the regulators.



Source: ABS; APRA; RBA

My conclusion is that investors should take heart from three facts:

1. The decline in asset markets is a consequence of the necessary lift in bond yields as inflation stirred. Bond yields were too low on any sensible analysis and their rise re-establishes the well-established connection of bond yields and the required return on risk assets.
2. The decline or adjustment of asset prices has already happened, with sharply higher bond yields and PER compression. Unless there is a global recession, investors should now be looking for appropriate investments to take them into the next growth cycle.
3. Australia remains uniquely positioned with a solid economic growth outlook, predictable population growth, an exceptional trade position, and a strong national balance sheet.

Whilst the short-term outlook for asset markets is by no means certain, it does appear that market price declines are once again an opportunity to buy superior cash-generating businesses or assets.

Australian asset markets are adjusting. Investors seeking income will secure a superior yield than that available in many developed economies.

Superior growth and superior yield suggest that patient Australian investors, appropriately diversified, will be well rewarded over the next few years.

John Abernethy is Chairman of Clime Investment Management Limited and Clime Capital Limited and Director of Jasco Holdings Limited and WAM Research Limited. The information contained in this article is of a general nature only. The author has not taken into account the goals, objectives, or personal circumstances of any person (and is current as at the date of publishing). Read Clime's November 2022 letter to investors here.

Is software the new shale?

Rajiv Jain and colleagues

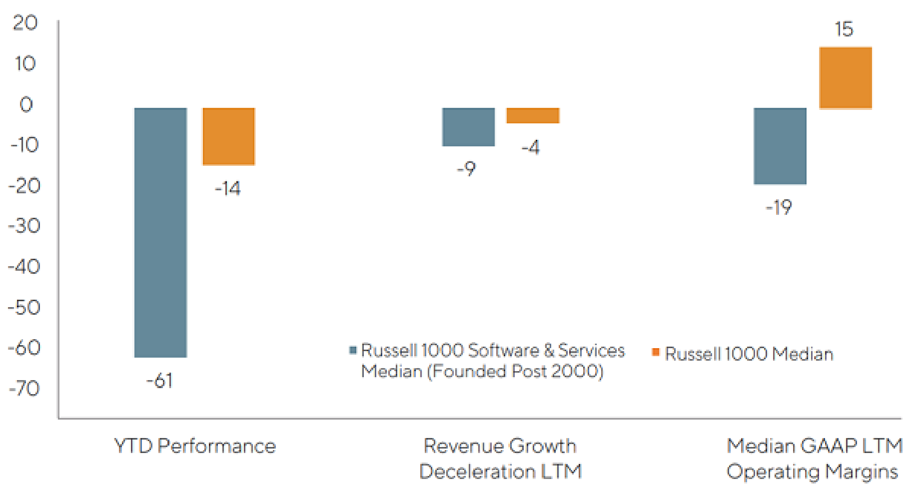
The software bubble appears to have popped but not everyone seems convinced. Getting off the train can be difficult as buying the dip in software has generally worked over the past decade. A similar dynamic took place in the energy sector boom-and-bust cycle in 2014. In fact, looking back at that period, we find many lessons from the US shale boom that are broadly applicable to the recent software boom. At a high level, we think both industries are representative of the excesses of the last decade driven by easy capital, as well as the dangers of ignoring capital cycles.

There seems to be a new disruptive technology that gets the markets excited in every cycle. A decade ago, it was hydraulic fracturing (which we will refer to as shale). In recent years, it has been software. In both cases, the market initially encouraged growth at all costs, highlighting strong unit economics, and adjusted valuation metrics that made the industry look profitable and cheap.

Eventually, supply flooded into the sectors just as demand started to decelerate. As energy investors learned the hard way over the past decade, no sector is immune to the basic laws of supply and demand – including the technology sector.

Looking at the software industry today, market participants seem to be reconnecting with reality, but they seem to have mixed views over the depth and duration of the downturn as discussions have shifted to whether the worst is over. The median drawdown year-to-date of the 46 Russell 1000 software companies founded post-2000 has been 61% through November (see Exhibit 1). Despite the eye-popping drawdown, valuations remain an issue, in our view. The median company in this cohort still trades at 6.1x revenue. Only 22% of the cohort is GAAP profitable.

EXHIBIT 1: SOFTWARE LAGGING THE BROADER RUSSELL 1000 IN 2022



Source: Bloomberg. Data for the YTD performance period and Trailing Twelve Month Return through November 2022.

We see fundamental issues with the industry. Nearly every software company has demonstrated broad-based growth deceleration from 2021 levels – the Russell 1000 cohort from above has a median revenue growth deceleration of 9% over the last twelve months. The story sold during the go-go years of 2020 has not played out – as it turns out, not every software company will become the next Microsoft, and software has not eaten the world.

The harsh reality is that most of the newer software companies have not built sustainable business models. Despite much excitement and broader industry growth, these companies have not delivered meaningful profit growth.

The median GAAP LTM operating margin in the Russell 1000 cohort is still -19%. Many investors may quote free cash flow multiples, but the open secret has been most of this 'free cash flow' is actually share-based compensation that is highly dependent on share prices (which have melted). If these companies could not become profitable during a massive boom period with strong software demand, when will they? We believe the combination of abundant capital, low interest rates, and strong industry growth during the past decade has resulted in weak, unprofitable business models for a number of newer software firms.

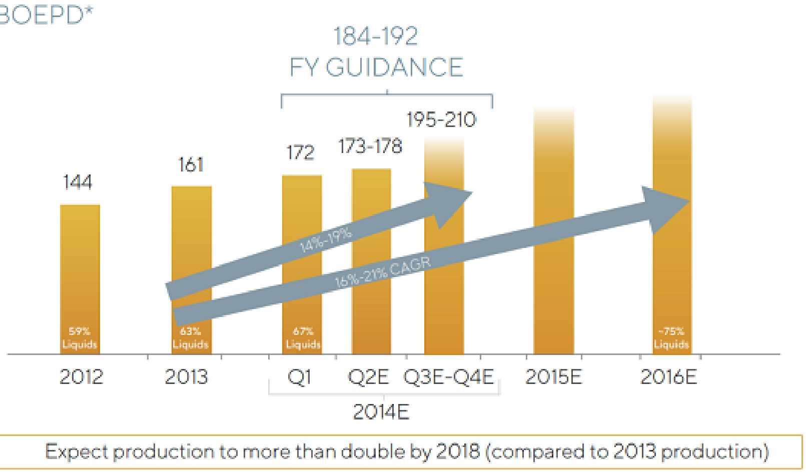
To be clear, we have owned select cloud software businesses in the past before cutting back in late 2021, especially as we started seeing signs of deceleration and lack of margin improvement. We believe the continued decline in growth has supported our decision to exit those names. Ahead of a difficult 2023 backdrop where software demand seems to be weakening, we expect revenue growth to further decelerate, margins to further compress, and free cash flow to decline. In other words, a toxic mix for any investment.

Lessons from US shale – a classic capital cycle

The similarities

Both industries were considered secular growth stories despite operating within lower growth areas – oil as a 1-2% industry grower and information technology (IT) spend as a 4-5% grower. Excitement about a new technology was central to the investment case for both industries. In the case of US shale, engineering technology revolving around hydraulic fracking and horizontal well drilling allowed oil operators to access oil resources that were previously difficult to harvest at lower costs. In the case of software companies, the advent of cloud architecture and better internet infrastructure allowed easier deployment, iteration, and adoption of software.

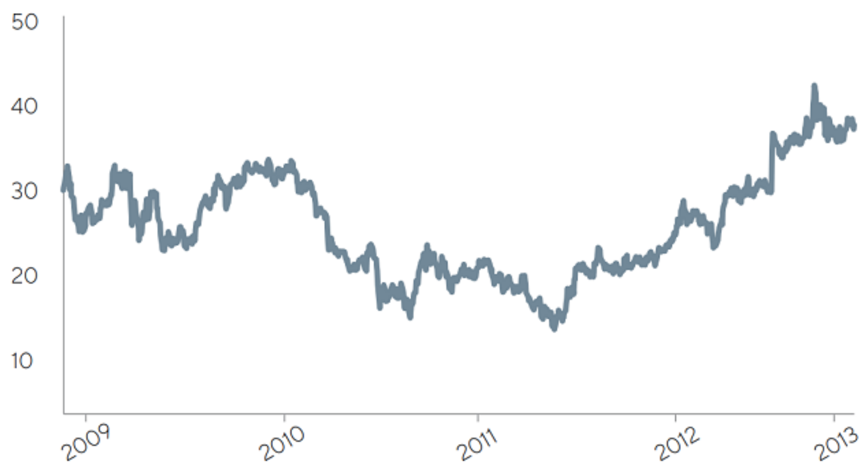
EXHIBIT 2: TARGETING 16% - 21% COMPOUND ANNUAL PRODUCTION GROWTH FOR 2014 - 2016



Source: SEC Filings. Pioneer Natural Resources 1Q14 earnings presentation dated May 7, 2014.
*All periods reflect Alaska and Barnett Shale as discontinued operations.

One major shale producer, Pioneer Natural Resources, targeted 16-21% annual production growth in 2014. As one broker noted back in 2015: "In a $75-80 oil world, PXD (Pioneer Natural Resources) can grow close to 20% for a decade and, hence, we view it as a large-cap must-own stock exiting this cycle, whenever you believe that is. We believe that clear bifurcation of US winners will attract capital and prevent PXD from getting 'cheap' on consensus metrics in a world where few assets are cheap."[1] As a result of this growth profile, the stock typically traded between 20x and 40x EPS during the shale boom. In our opinion, that sounds like the current pitch for software, as Gartner estimates >20% cloud software growth in 2023 despite overall IT spending only growing 5%.

EXHIBIT 3: PIONEER NATURAL RESOURCES NTM P/E MULTIPLE(X)

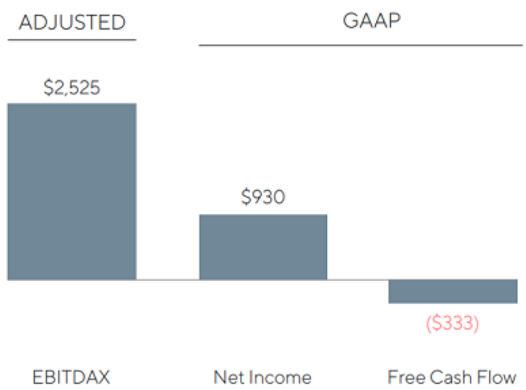


Source: Bloomberg. Data for the period December 31, 2009 through December 31, 2013.

As investor enthusiasm increased, companies created new metrics such as 'lifetime value to customer acquisition costs' (LTV to CAC) in the case of software and 'oil well IRRs' in the case of US shale. Both pointed to stellar unit economics and non-GAAP metrics to distract from the lack of cash flow and profitability at the company level. Investors bought into the narrative, believing that profitability would inevitably come once companies scaled up. To quote one respected bulge bracket analyst in 2015, "we believe as shale matures and industry growth profiles taper, at various rates, E&P (exploration & production) FCF will inflect, growth will slow, and shareholder returns will increase: the same path followed by many large caps before them".[1]

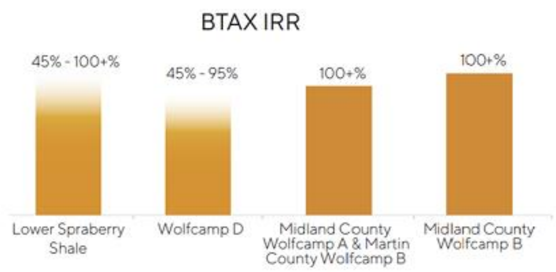
Those who followed the oil space back in the 2014 era probably recall optimistic projections of >100% 'well IRRs' and EBITDAX valuation metrics (which conveniently ignored depletion, depreciation and amortization, and exploration expenses). Ultimately, these forecasted returns were difficult to realize as management teams and analysts failed to account for the significant fixed costs in the business and the implications to consolidated margins. We believe a similar mistake is being made with software today – the myopic focus on LTV to CAC misses the fact that the median Russell 1000 business spends ~20% of revenue on research and development – excluding management overhead – weighing on consolidated margins.

EXHIBIT 4: PIONEER NATURAL RESOURCES
Fiscal Year 2014 Financials ($MM)



Source: SEC filings.

EXHIBIT 5: PIONEER NATURAL RESOURCES FY14 FINANCIALS
Northern Horizontal Well Economics*‡

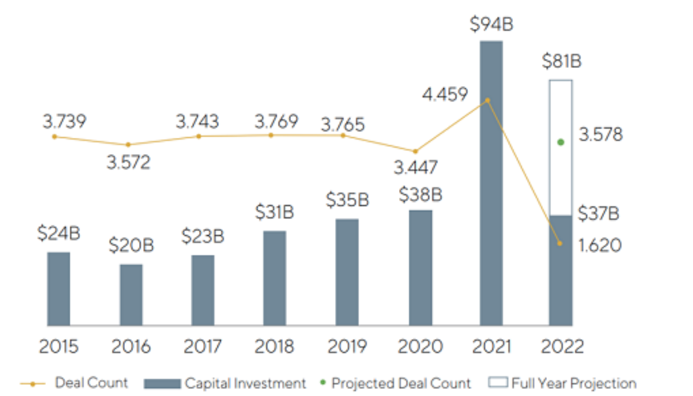


	Lower Spraberry Shale	Wolfcamp D	Midland County Wolfcamp A & Martin County Wolfcamp B	Midland County Wolfcamp B
EUR (MBOE)	575 - 1,000	650 - 800	800	1,000
D&C Cost ($MM)	$7.5	$8.5	$8.0	$8.0
Payout Years	1.0 - 2.5	1.3 - 2.4	1.1	1.0

Source: SEC Filings. Pioneer Natural Resources 1Q14 earnings presentation dated May 7, 2014.
*Pricing: $90/BBL for oil and $4/MCF for gas. ‡Reflects 7,000' latertal length, single well drilling cost and no "science".

Ultimately, both industries turned to capital markets to fund losses. Hundreds of billions of dollars have entered both the US shale and software as a service (SaaS) industries over the last decade. For US shale, [Deloitte estimates] that from 2010 through 2020, industry free cash flow was negative $300 billion, relying on a combination of debt and equity to plug the cash flow gap. Similarly, in software, venture funding for US businesses has totalled greater than $300 billion since 2015. Even public companies have continued to rely on external financing: the Russell 1000 cohort issued ~$17 billion in share-based compensation over the last twelve months – which we view as the equivalent of equity financing, no different than if a company went to the equity markets and issued shares for cash. In other words, external capital entering the software industry has actually exceeded that of the then much-reviled shale industry.

EXHIBIT 6: US SAAS VC DEALS AND INVESTMENT



Source: Pitchbook. Data as of June 9, 2022 and subject to change due to data updates or methodology changes by PitchBook; deal count and capital invested excludes PE Growth and Corporate deals. SaaS vertical defined using PitchBook's methodology for industry verticals.
Source: PitchBook.

Tech's ESG issues: poor governance

Poor governance at many software companies presents meaningful ESG risks, even if software optically checks off the boxes in the 'environmental' and the 'sustainable' categories. Technology investors have largely overlooked governance issues in the past given the strong revenue growth profile of software companies in an era of weak overall economic growth. However, now that the industry has hit challenging times, poor governance practices are more in focus. Management teams seem to be running away from issues instead of facing them head-on. Examples of these poor practices include top-up compensation and sale processes.

Top-up compensation: Because talent had been so scarce on the software development side, companies would give out significant equity packages that vest over four years and usually at discounts to market prices. In the off-chance the share price ended up lower than expected, many employers would top-up and make up the difference with additional equity grants. It is a pretty good deal for the employee – unbounded upside and no downside. Equity shareholders, of course, are the losers in all of this because dilution ends up higher and GAAP margins end up lower. Zoom, one of many examples we can point to, has seen share-based compensation balloon to 27% of revenue in the most recent quarter versus 10% of revenue in 2020. GAAP operating margins peaked at 29% in the quarter ending January 2021 but have declined to 6% in the most recent quarter.

Sale processes: We have already seen many management teams throw in the towel and elect for take-privates. Previous darlings like Citrix and Avalara were recently purchased while a few others including Coupa have recently reached an agreement with a private equity company. Most of these take-private prices have been at meaningful discounts to all-time-highs, much to the detriment of public market investors. These take-privates have come after some deceleration in the fundamental businesses but represent poor governance, in our view.

We do not believe that boards nor management teams have been penalized for poor governance. On the contrary, many boards and management seem to be incentivized to execute on governance practices detrimental to shareholders. Unfortunately, we think governance violations will continue with impunity, another risk many investors have overlooked over the last decade, as many management teams and boards are not aligned with the interests of investors.

The differences

Technology investors would point to one major difference between software companies and oil companies: pricing power. Oil is a commodity, whereas software can theoretically raise prices on customers due to the high switching costs. However, the reality is that most software companies have not actually flexed their pricing power.

At Salesforce, for example, pricing has not been a material factor for revenue growth in the past few years. Instead, the company elects to engage in cross-selling or up- selling to grow spend within a customer. However, the 'maintenance' of said customer likely gets more expensive over time due to rising salaries, product development costs, and increased hardware, datacenter, and cloud costs. In short, the unit economics degrade over time, as evidenced by the decline in Salesforce's gross margin from 80% in 2010 to ~73% in the most recent quarter. We believe the company's margin profile and total revenue would look significantly different if they had flexed their theoretical pricing power.

Conclusion

It's finally time for the rubber to meet the road, and unfortunately, we do not think most software companies are prepared. With that said, we will continue to monitor new data points and look for the exceptions, which may present interesting opportunities. But looking at the industry as a whole, it is hard to ignore the similarities – so for now the question remains: Why can't software be the new shale?

[1] Morgan Stanley – "Pioneer Natural Resources: Upgrading the Archetypal Shale Stock" – 7/13/15

Rajiv Jain, Chairman and Chief Investment Officer, alongside Brian Kersmanc and Sudarshan Murthy are at the helm of the Investment Management Team serving as Portfolio Managers for the GQG Partners portfolios. This article contains general information only, does not contain any personal advice and does not consider any prospective investor's objectives, financial situation or needs.

2023: inflation, diversification, agility and an eye to recession

Stephen Miller

As we enter 2023, I approach the task of previewing economic and financial developments with more than the usual trepidation.

In the first place, we may not be in uncharted waters but certainly unusual currents: high and stubborn inflation, rising interest rates and near constant warnings of imminent recession. The latter has been on the radar of the market commentariat for some time. That is understandable, but at the same time there is little evidence that a substantial economic activity dislocation is in the offing.

A second observation is that I'm not sure the lessons of both recent (post-pandemic) history and lessons of decades past (the high and persistent inflation of the 1970s) have been properly digested by markets and some central banks, including the Reserve Bank of Australia (RBA).

In terms of the post-pandemic period there is an enduring narrative that current inflation – while a little stubborn – is a temporary phenomenon reflecting pandemic-induced supply chain disruptions and outsized increases in the prices of a few selected commodities (largely, but not solely, energy related) that were given further impetus by the Ukraine conflict.

Under this construct, central banks have, after varying degrees of prevarication, met the inflation challenge. Policy rate adjustments from here on in, including in Australia, will be modest, if they are needed at all. Inflation will decline smoothly through 2023 and the big challenge for central banks will be avoiding recession rather than a focus on inflation.

Given that circumstance, the US 10-year bond yield is probably range-bound around a mid-point close to 4% and arguably offers investors an attractive yield without the prospect of significant capital losses.

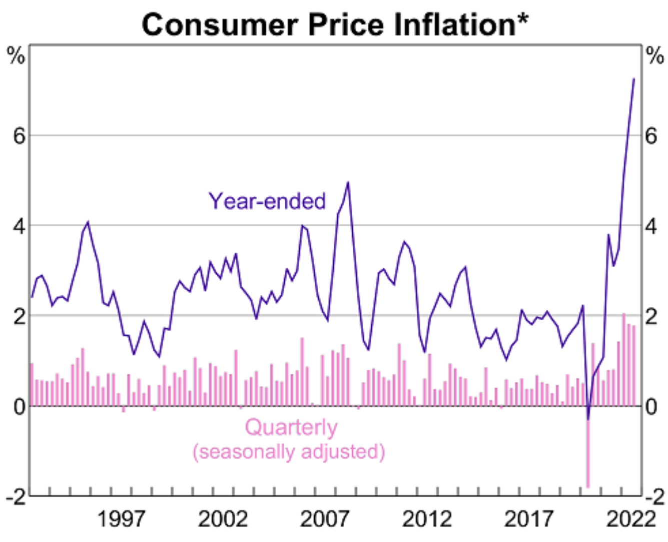
That might be good news for US equity markets, representing as it does the abatement of what has been a significant valuation headwind. However, while equities benefit from stabilising bond yields, the question remains whether earnings estimates have appropriately priced the cyclical downside. Depending on the extent of cyclical downside, equities seem likely to offer at least low single digit returns and perhaps significantly more if any recession is shallow and short-lived.

Why inflation could prove sticky

That scenario is plausible but there are vulnerabilities and limitations to the logic of that narrative that investors should heed.

For one thing, there seems little appreciation of where monetary policy has come from. The pandemic saw monetary policy assume unprecedented levels of accommodation. Viewed through that lens, policy adjustments through 2022 may have represented a return to some version of normality and perhaps (the US aside) significantly tighter conditions are required to meet the inflation challenge, including in Australia. In the US, policy rate increases through 2023 may be modest but any reversal may take a little more time than markets currently contemplate.

Second, the prevailing narrative on inflation fails to recognise that inflation tailwinds are more pervasive than the consensus commentary might have it. While measures of the US inflation pulse are showing meaningful deceleration, the big question regarding future inflation is over the trajectory of services inflation. It reflects the 'stickiness' in services inflation that Federal Reserve officials are reluctant to eschew the option of further tightening – to declare 'mission accomplished' – even if positive US inflation portents are



* Excludes interest charges prior to the September quarter 1998; adjusted for the tax changes of 1999–2000.

Sources: ABS; RBA

clear. Elsewhere, including in Australia, the inflation picture is less encouraging.

The supply-side inflation narrative also downplays the reversal of structural currents that account for the deflationary tendency of the past three decades: globalisation of labour supply (after the fall of the Berlin Wall and the 'export' of labour from large emerging market economies such as China and India) and peak baby boomer workforce participation. Other factors such as de-globalisation and re-regulation are also relevant.

In short, the disinflationary narrative and the assumed financial market consequence is a very US-centric one.

The RBA may be wrong again

Locally, the RBA finished 2022 with its hard-won reputation battered and bruised by a ham-fisted approach to policy and the communication thereof through 2021 and into 2022.

Of course, the missteps in RBA communication, including the "no increase in the policy rate before 2024" have been well documented. However, it is more important to recognise that the substantive error that led to that flawed policy communication was an underappreciation of the persistence and magnitude of inflation.

There appears some risk that the RBA continues to underappreciate current inflation pressures. In my view, domestic interest rate markets may similarly underestimate inflation momentum and the policy rate implications.

Some of the RBA caution reflects a belief in 'Australian exceptionalism': the notion that Australia's wage and inflation circumstances are somehow less challenging than elsewhere in the developed country complex. The evidence for such 'exceptionalism' is scant.

Indeed, well-intentioned but fundamentally flawed changes to the regulatory environment, particularly in relation to the wage-setting framework, run the risk of entrenching higher inflation in Australia compared to elsewhere.

High frequency data such as the NAB monthly business survey continue to indicate considerable wage and price momentum into 2023. That shouldn't surprise: the unemployment rate is at its lowest in almost 50 years.

The RBA has defended its comparative caution by warning against "scorching the earth" to get inflation down, implying a more aggressive approach involves outsized costs in terms of activity and employment.

But drawing on the 1970s experience, an alternative construct is that that the 'scorched earth' more likely comes from central banks exhibiting some prevarication in assuming an aggressive role in containing inflation and then having to slam the monetary brakes later in the piece.

The key risk with the RBA approach is that it admits the possibility of the emergence of the sort of inflation inertia that was last experienced on a global scale in the late 1970s and early 1980s.

As the RBA Governor has noted, the path to returning inflation to the 2-3% target and keeping the economy on an even keel "is a narrow one."

Even so, it will be closely monitoring wage and price developments and should be possessed of an acute inflation anxiety as it approaches 2023.

Local interest rate markets should well heed that anxiety. In my view the domestic commentariat and market pricing of the policy rate reflect some complacency on the inflation front.

Diversification is as important as ever

For investors the key lesson is perhaps an obvious one: diversification. That has a particular poignance given a highly uncertain global economic environment.

The foundation of an investment portfolio should be both equity and bond beta, but they are the foundations only and should not comprise the sole components of a portfolio. Nor should the beta be comprised solely of domestic assets. If the RBA maintains its comparative caution that could be a headwind for the Australian dollar unless and until it reverses course. Domestic bond yields may have greater upside risk if the domestic inflation genie escapes the bottle, perhaps implying greater headwinds to domestic equities, particularly if wage and other costs accelerate sharply.

More poignantly investors should be seeking strategies that are non-correlated with equity and bond beta. This may include inflation-linked bonds, commodity exposure (including a small allocation to gold), long/short equity and bond strategies, macro hedge fund strategies, and 'stylised' equity tilts (e.g., defensive equity) to name a few.

The last word is agility, implying a modicum of liquidity. I mentioned at the outset 'unknown unknowns'. A diversified portfolio is a buffer against that. Agility allows portfolio shifts as information sets are updated.

Stephen Miller is an Investment Strategist with GSFM, a sponsor of Firstlinks. He has previously worked in The Treasury and in the office of the then Treasurer, Paul Keating, from 1983-88. The views expressed are his own and do not consider the circumstances of any investor.

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Electric vehicles and Elon Musk have serious problems

Peter Zeihan

This is an edited transcript of a video talk given by geopolitical strategist, Peter Zeihan, on electric vehicles.

I thought it's time to talk about electric vehicles (EVs) and why they are not going to be an appreciable part of our transport future for at least the next decade, probably closer to three.

They aren't environmentally friendly

First and foremost, from a carbon point of view, EVs really don't stack up very well. They are among the most energy consumptive projects that humans have engaged in at this point. Even if you use Tesla data, which is biased and incomplete, they only deal with the battery assembly, and they assume 100% clean power for recharging your vehicle and 100% clean power for making the vehicle. They still say that on a standard grid that is 100% green, it's still going to take you over a year to break into some sort of neutrality compared to the carbon footprint of the conventional vehicle.

Now, if you include the fact that almost all of the processing for all of the materials and all the mid assembly is done in China on coal power, and if you include the fact that things like the frame - which doesn't go into their [Tesla's] data - are made out of a silicon aluminum alloy, which is incredibly energy intensive, you're really talking upwards of five and maybe as many as 10 years. And if you're talking about a more conventional grid like in the United States, you have to increase it from there. The numbers, at least for now, just aren't there from a green point of view.

Cost is a problem

There's also the cost issue. You can't get a lot of power, at least over sustained periods, from an electric vehicle that you can get from a more conventional system. Right now, we technically do have the innovations and the technologies necessary to go EV for our light vehicles and our light trucks, passenger cars, small pickups, that sort of thing. But we don't have anything for the more powerful vehicles such as semis or airplanes or ships that actually make up over half of tonne miles in the world. And even in those lighter categories, it's a bit of a question mark.

But what the really big issue comes down to is whether we can do it at all from a physical point of view. Forget the cost, forget that these things are, for the most part, carbon bombs. Look at what it takes to make these things. If you want to make a conventional vehicle, obviously the energy that is required comes from the fuel.

But if you want to make an electric vehicle, you have to put in a much more sophisticated system that has a lot more material inputs and order of magnitude more material inputs, the aluminum, the silicon, the graphite and so on, And we need so much more of that if we're going to make this happen. We need at least double the amount of copper and zinc. We need at least four times the amount of chromium and molybdenum. And we need at least 10 times the graphite and the lithium. The world has never been able to increase the volume of something that it needs, whether it's vegetable or animal or mineral by a factor of 2 in a 10-year period at any time in world history and any technological age.

But we're going to increase the amount of lithium that we kick out by a factor of 10 in eight years? I don't think so. And it's worse than it sounds because we're losing a lot of the material production, a lot of the processing capacity.

Russia is a top three producer of things on this list, like zinc and copper and nickel. And then, China is in a top three position for the processing for all of them, and typically number one for all of them. Well, we're going to lose the Russian stuff because of sanctions in the Ukraine war. Even if sanctions do no damage to this industry, the Russians have proven time and time again that they can't maintain their own infrastructure without foreign investment and workers, and they're gone.

And the Chinese system is dependent upon an economic model that is in its dying days because globalization is over. They don't have the demographic structure to make it happen in the first place. And the capital that would be necessary to make all of this work even theoretically is also gone because that's wrapped up in the retirement of the boomers. As they liquidate all of their holdings and move into retirement, they're not going to be able to afford the sort of risk that it takes to invest in cobalt production in Congo. They're going to be going into municipal bonds. That doesn't generate a lot of chromium.

And if we start having to make economic and environmental decisions based on material constraints, then it's just a lot more cost effective and carbon effective to pour money into wind turbines outside of Oklahoma City or solar panels outside of Phoenix than it does to build carbon bombs for our cities.

We need to talk about Tesla

Most Teslas that are on the road right now are not a first car or a second car. They're a third or a fourth car. They're status symbols. They're conspicuous consumption at the highest level, which means that we really do need to talk about Tesla.

Three problems there. First, we call 'the Elon factor'. He has decided to showcase some of his personal politics, which are a little erratic. And they tend towards the Trumpian and the conspiratorial right. But most of the people who have been buying Teslas to this point are armchair environmentalists who think that they're better than everyone, and they're not interested in something that supports that general point of view. So, he's basically alienated his primary consumer base.

The second problem is that Tesla is priced as an information technology company like Google or Facebook. And that's a very different model. When you develop something in the information technology space, you can then sell it over and over, because the marginal cost of producing next unit is nearly zero. But when you're doing automotive manufacturing, you have to produce each and every vehicle independently and sell them independently.

Source: Morningstar

The first one is nearly infinitely scalable. The second one is linear. In an infinitely scalable environment, of course, the capital that flows in to develop the model and develop the workforce and develop the skill sets and the patents, it comes from everywhere, and that's why you see massive valuations in that space. But when you're only selling one vehicle at a time, you can only maintain those valuations so long as you are the only producer, and that is not the case for Tesla anymore.

Yes, Tesla was the world's largest producer for a while, but now, every major automotive company in the world has an EV line. And in many cases, these are vehicles with more towing capacity, more weight capacity and better range than Tesla has.

Tesla still has this panache as a luxury brand, but he's offended the people who bought it for luxury reasons, which brings us to the third problem. We're facing a massive capital crunch, and that's not something that's simply going to affect the financing for vehicles or the mining of materials, but the capital that is available to keep Tesla stock above board at all. We have seen Tesla drop by about 70% in calendar year 2022 as some of these factors have kind of come out indirectly.

For Tesla to be ranked, to be priced like a normal automotive company - normal automotive companies that in many cases now have superior EV models and a better income stream and more experience making vehicles - Tesla needs to drop by 90% from where it began this calendar year. That would bring it even with Ford and Chevy and the rest. And that's before you consider that Elon has systematically offended most of his existing customers.

Peter Zeihan, founder of Zeihan on Geopolitics, is a geopolitical strategist, speaker and author. This article is general information and does not consider the circumstances of any investor. This article is an edited transcript of Peter's video, EV's Not-so-little Dirty Secret(s), posted on 4 January 2023.