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Editorial

Although commonly attributed to **Winston Churchill,** he was not the first to say the famous words:

> *"Democracy is the worst form of government, except for all the others."*

What he did say (on 11 November 1947) is similar but more expansive:

> *"Many forms of government have been tried, and will be tried in this world of sin and woe. No one pretends that democracy is perfect or all-wise. Indeed it has been said that democracy is the worst form of government except for all those other forms that have been tried from time to time …'*

Despite the extraordinary achievements and progress of billions of people over centuries, we have not improved on a system of government which involves a person walking into a polling booth every few years and marking a box for a preferred candidate. Democracy comes with troublesome flaws such as media influence, lobbyist access to politicians for favours, backroom deals, party politics and faulty personalities, but theocracy, autocracy or oligarchy are worse.

Democracy is dysfunctional but we have not come up with anything better.

Monetary policy is the same. It is flawed in its application but we have not devised an improvement, such that our central bank's attempts to fulfill its responsibilities under the Reserve Bank Act are blunt and imprecise. The Act says:

> *"Its duty is to contribute to the stability of the currency, full employment, and the economic prosperity and welfare of the Australian people."*

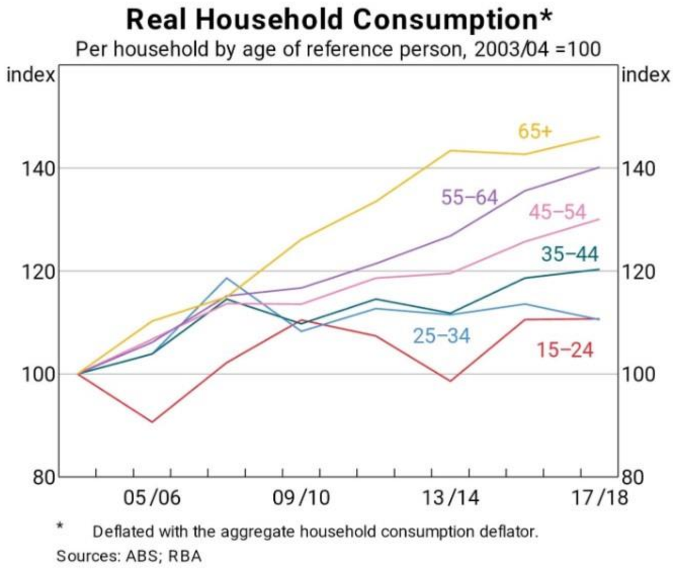
Look up '[monetary policy' on the Reserve Bank's website]() and it says:

> *"The Reserve Bank is responsible for Australia's monetary policy. Monetary policy involves setting the interest rate on overnight loans in the money market ('the cash rate').*

That's mainly it. The cash rate, plus some activities on money supply. To contribute to the prosperity of the Australian people, the central bank weapon of choice is setting the cash rate. Consider some way this fails:

1. There are about [10 million households in Australia (ABS 2022)]() but only one-third of them have a mortgage. Most people are not hit by higher mortgage payments, yet that is the primary inflation control mechanism.

2. Increasing the cash rate stimulates the economy by boosting the nominal incomes of millions of Australians through higher term deposit and bond rates. If anyone argues it is not stimulatory because the older people who are the savers do not spend as much as younger people, consider this chart (right).



3. Fiscal policy often works in the opposite direction, as governments give cost-of-living relief when inflation rises, putting money into pockets when the central bank is trying to take it out.

4. Monetary policy is primarily demand-side economic management. It aims to expand or contract economic activity by controlling the cost of money. But in the current cycle, inflation is significantly driven by supply-side factors, such as Russia's war in Ukraine, the pandemic's impact on supply chains and natural disasters in Australia. None of which are sensitive to interest rate changes.

5. Rising cash rates feed into parts of the inflation calculation, the Consumer Price Index (CPI), generating an updraft. The **Australian Bureau of Statistics** advises:

> *"Housing is the highest weighted group in the CPI, accounting for around one quarter of the basket. It includes new dwellings purchased by owner occupiers (houses, townhouses and apartments), rents and major renovations."*

Consider how supply shortages have driven up inflation, contributed to a decline in construction and rising rents. Says **Bill Mitchell**, **Professor in Economics and Director** of the Centre of Full Employment and Equity at the **University of Newcastle:**

> *"So we enter a ridiculous circularity. The RBA hikes interest rates. Rental inflation accelerates even though the other factors driving the overall CPI inflation trajectory are in decline. The RBA then claims the CPI inflation is not falling fast enough. The RBA hikes again … Rinse and repeat."*

Borrowers who can least afford higher repayments are hit the most. Its doubtful they feel an increase in the cash rate 11 times in a year from 0.1% to 3.85% has improved "*the economic prosperity and welfare of the Australian people*".

The **Reserve Bank** and **Governor Philip Lowe** are acutely aware of the mental health implications of rising rates, and the Governor has made a point of meeting with suicide prevention agencies. The May 2023 Statement of Monetary Policy (page 32) includes this acknowledgement:

> *"Community services organisations have raised concerns regarding the sharp increase in demand for their services over recent quarters, including for financial aid, domestic violence and acute mental health support, food bank services and housing assistance. They note that there has been a rise in the number of people seeking assistance for the first time, including renters and people with mortgages."*

A policy which causes severe mental health problems for strugglers but puts more money in the hands of wealthy savers is a deficient way to control inflation. The Reserve Bank acted the worst when leaving the economic stimulus of '*whatever it takes*' in 2021 as inflation was already taking hold. It poured fuel on the fire when it should have withdrawn oxygen.

Of course, Australia's central bank was not alone, and this week, we publish a short extract from famous fund manager **Stanley Druckenmiller**'s recent interview at the **Sohn Conference 2023** in the US where he says of the **Federal Reserve**'s actions a year ago:

> *"Then realising they have probably made the biggest mistake in the history of the Fed, they slammed on the brakes. They raised rates 500 basis points (5%) in the last year."*

> *"I'm sitting here staring in the face of the biggest and probably the broadest asset bubble, forget that I've ever seen, but that I've ever studied."*

> *"If we get a hard landing, there will be unbelievable opportunities, and I don't want to miss those opportunities by blowing my money now and having some 20-30% loss where my head is all screwed up when those opportunities present themselves."*

The Federal Reserve Act was signed into law in 1913, about 110 years ago, and for a leading voice in US investing to call the extremely loose monetary policy of 2021 "*probably made the biggest mistake in the history of the Fed*" is quite a claim.

This week's wage price index showed a rise at a decade-high 3.7% in the year to March 2023, and 0.8% for the quarter, both in line with expectations. After the release of the Reserve Bank minutes on Tuesday, **CBA's Gareth Aird** confirmed:

> *"Our central scenario puts the current 3.85% as the peak in the cash rate, while the near-term risk sits with another rate hike ... We continue to expect 50bp of rate cuts in Q4 23 and a further 75bp of easing in 2024 that would take the cash rate to 2.6% - a more neutral setting."*

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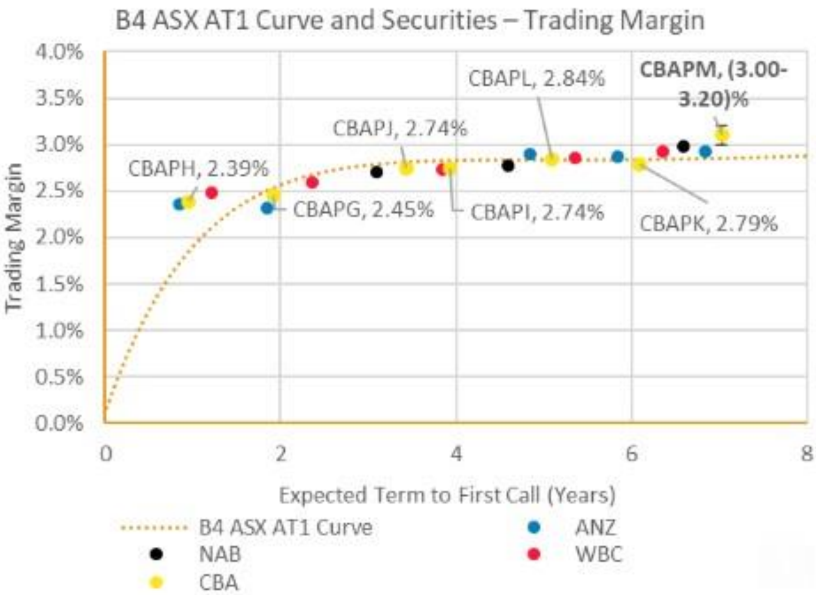
CBA has a new hybrid in the market, expected to list as CBAPM with an indicative margin of 3% to 3.2% and issue size of $750 million. The Bank will be swamped by demand, given the Bank Bill Rate is now about 3.9%. NAB economists came out this week expecting one or to more cash rate increases. Either way, a gross return of about 7% on CBA is a decent reward for the risk of hybrids. This chart courtesy of **BondAdviser** shows the relative value and extra return for longer term.



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As 30 June is six weeks away, the **Australian Taxation Office** (ATO) has advised its [three focus areas] for this tax period:

- rental property deductions
- work-related expenses
- capital gains tax.

The ATO is especially critical of rental property owners:

> *"The ATO's review of income tax returns show 9 in 10 rental property owners are getting their return wrong, and often sees rental income being left out, or mistakes being made with property related deductions – like overclaiming expenses or claiming for improvements to private properties."*

The ATO has sophisticated data matching capabilities, and warns:

> *"Don't fall into the trap of thinking we won't notice if you sell an asset for a gain and don't declare it ... Don't bury your head in the sand."*

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In the time-honoured tradition of the Commencement Speech loved by US universities, **Bill Gates** gave the 2023 version to North Arizona students last week. As Gates says, he never actually graduated from any university, as he left **Harvard** after three semesters to start **Microsoft**. He's done well regardless. The advice he shared is worth a quick read, making these five points:

1. Your life isn't a one-act play.
2. You're never too smart to be confused.
3. Gravitate toward work that solves an important problem.
4. Don't underestimate the power of friendship.
5. You're not a slacker if you cut yourself some slack.

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Buy-Write funds have been available to retail and wholesale investors in Australia for many years - I worked on the design of one at **Colonial First State** about 20 years ago - but they are becoming more common, including many ETFs. Several new funds have launched on the **ASX** and **Cboe** listed exchanges in recent months. How do they work and do they suit the current market conditions?

Graham Hand

Also in this week's edition ...

The Quality of Advice Review has once gain shone a spotlight on the escalating costs of financial advice. While there have been a lot of vague statements about advice fees, they've been few specifics on the actual costs involved. **Anne-Marie Esler** from **Padua Solutions** breaks down the fees for us. She notes that while costs are skyrocketing, demand for financial advice remains strong.

Nicholas Paul of **MFS Investment Management** hails the cheapest global small cap valuations seen in decades. He says there are similarities between the market set-up today and that of the early 2000s, after which small caps beat large caps handsomely over the next eight years.

Look up any reputable finance book and you're likely to see a statement about how bonds offer lower returns than stocks although with less risk. **Andrew Mitchell** of **Ophir Asset Management** takes issue with the latter. He says that while it may be true in the short term, it isn't over longer-time horizons, with important implications for asset allocation.

The charge towards net-zero emissions is a US$50 trillion global opportunity over the next 30 years, according to **Munro Partners' James Tsinidis.** James gives us three themes and one stock that should benefit from the climate transition.

Professional money managers have many advantages over individual investors: more information, greater access to company management, as well as staff to help them. Yet they also have some constraints, and it's here **James Gruber** suggests that individuals can potentially compete with the best in the business.

And in this week's white paper, **Orbis Investments** seeks to debunk three oft-repeated myths about value investing with hard data and considered analysis.

Curated by James Gruber and Leisa Bell

The latest costs and strategies in financial advice

Anne-Marie Esler

The financial advice landscape is influenced by the priorities of the government of the day, legislative changes, pressure from regulators, and the ever-increasing licensee and compliance standards. Most recently, following the release of the final recommendations to the Quality of Advice Review (QAR), the industry is waiting the Government’s response, long past the expected timing.

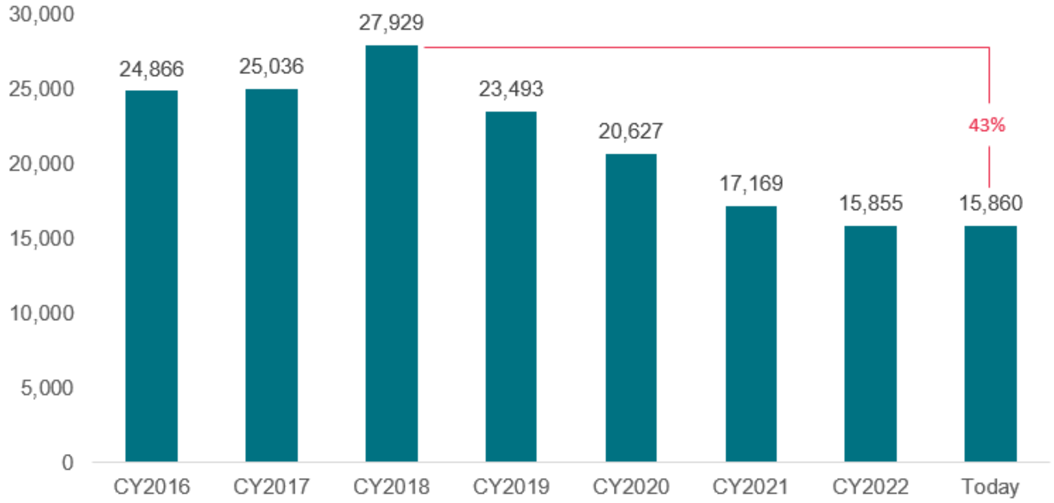
These influences have impacted the way advisers provide advice to Australians who are seeking to improve their financial position over the course of their life.

Adviser numbers down

Against this backdrop is a significant decrease in adviser numbers in Australia over the past few years. From a high of 27,929 in 2018, only 15,860 qualified, financial advisers are listed on the Australian Securities and Investment Commission (ASIC) register, a decrease of 43%.

In contrast to the decline in existing adviser numbers is the growth in provisional and new advisers joining the industry. This has contributed to the slight increase in adviser numbers between December 2022 and now.

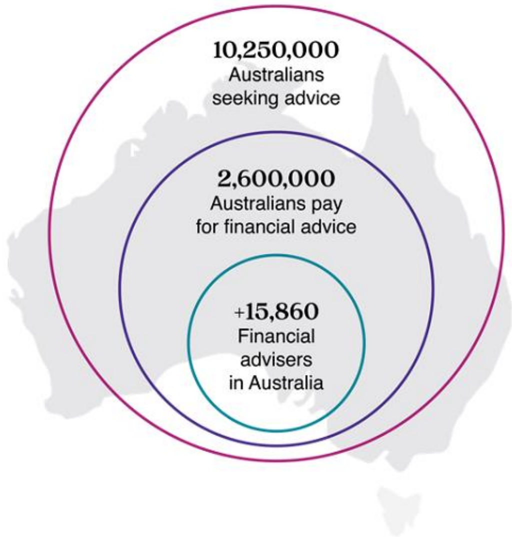
The reasons for the decline are many and varied and include increasing education requirements, regulatory pressures and rising compliance burdens, and the difficulties of operating in an ever changing environment.



Source: WealthData

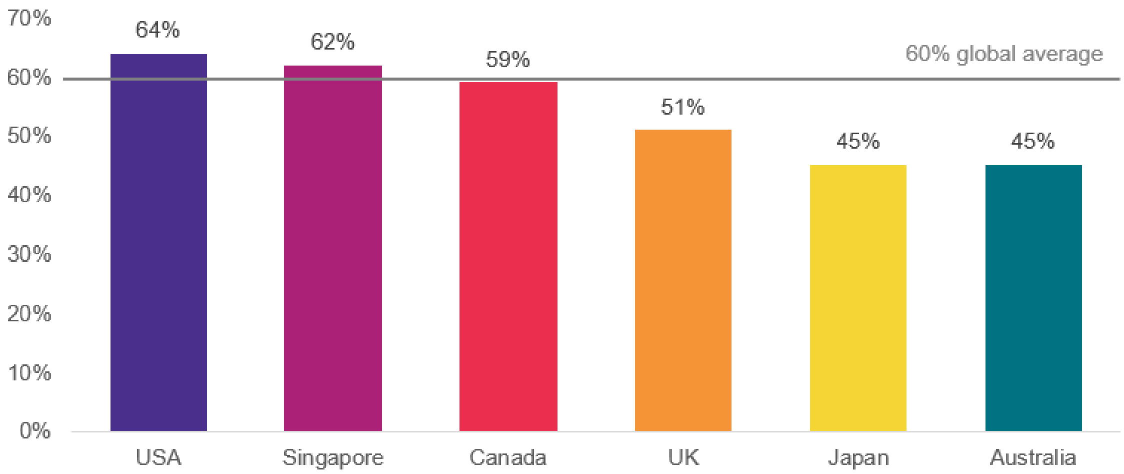
Australians need more advice

Despite this reduction in the number of financial advisers, Australians need advice more than ever and they are seeking financial advice in increasing numbers. A recent ASIC report noted that 2.6 million Australians are currently paying for financial advice however 10.25 million Australians would like to receive financial advice at some time in the future.



There are some barriers to Australians paying for and receiving financial advice including that the cost of advice is too high and that too few Australians trust financial advisers.

Thankfully for those of us working in the financial services industry, the level of trust has increased in recent years. In 2020, the CFA Institute's Investor Trust Study showed that only 24% of Australians trusted the financial services industry. The latest report, released last year, shows that trust levels have risen to 45%. Although still below the global average of 60%, the significant increase is consistent with that experienced across the globe, with the report citing trust levels are at an all-time high.



The cost of advice?

How much does financial advice cost? Our data is sourced from our work producing thousands of advice documents (called Statements of Advice) each year, across multiple licensees and adviser practices. We can capture the upfront fees and ongoing fees charged by financial advisers.

Upfront fees are charged when a client initially receives advice and may include capturing the client's existing situation, researching the potential options that may add value to the client's position, determining the most appropriate strategy and product recommendations, the cost of producing the Statement of Advice document itself and the cost of implementing the advice.

Ongoing fees are quoted as an annual figure but are normally charged monthly over the course of a year. They can be paid directly by the client or deducted from the client's portfolio as a flat dollar or percentage-based fee. Ongoing fees are charged by the adviser to provide continuous advice which includes reviewing the client's portfolio and performance on a systematic basis, providing regular updates to the client, making small changes to the client's portfolio (e.g. rebalancing back to the client's risk tolerance level), and maintaining the client's records.

There are many different ways that advisers can charge fees, including:

1. A set annual fee based on the type of client and services required.

- A pre-negotiated fixed fee is the most common. Payment frequency varies but is often monthly. It can be deducted from a bank account or product, if the product allows. There may also be caps on how much can be deducted from a product.
- A pre-negotiated fee based on asset levels, which is less common. This is a rate that is usually collected via a product and is based on an average balance over a defined period, such as a month. Not all products facilitate this. Some product providers will exclude the cash hub balance when determining the fee and others will not.
- A combination of a fixed fee and an asset-based fee. With an asset-based fee, the adviser needs to provide a reasonable estimate of what the fee is likely to be and outline the assumptions used to work this out.

2. A percentage of Funds Under Management (FUM).

- Some advisers charge a percentage of FUM but care is needed to define what is included.
- It is possible to charge based on non-platform asset values, but it can be difficult to manage. For example, the family home is not in the mix as a financial adviser does not provide advice or service in relation to that asset, but what happens with an investment property?

3. An hourly rate.

- Some advisers charge by the hour. It creates transparency but there are challenges, for example, if an adviser has invested heavily in processes and technology to improve the efficiency of delivering the advice. It may take them less time to complete but the adviser still needs to receive a fair compensation for their time as well as the costs of building and maintaining their processes and systems.

Licensees may impose restrictions on minimum and maximum fees charged as may product providers. On the latter, such restrictions will not limit how much an adviser can charge, but it can limit how much can be deducted via the product.

The adviser must always charge what is fair and reasonable. This is a requirement under the Code of Ethics and the regulations. The adviser must be able to defend the charges, agree the amounts with the client in advance, and document them in the Statement of Advice to ensure there are no surprises for clients.

The following diagram captures the average upfront and ongoing fees that were charged by financial advisers using our software for the 2021 and 2022 financial years.

	FY21	FY22	Increase
Initial Advice Fees	$2,859	$3,315	16% ↑
Ongoing Advice Fees	$3,656	$4,865	33% ↑

There has been a significant increase in advice fees charged by financial advisers over the past two years, particularly the level of ongoing fees. This trend is set to continue as we are seeing further increases in advice fees this financial year.

Financial advice fees have risen in line with the increasing costs of providing that advice. One of the main contributors is the regulatory burden on financial advisers which has increased exponentially, requiring them to devote more time to ensuring advice documentation adheres to compliance requirements.

The exodus of advisers from the financial advice industry has only exacerbated existing concerns around the cost and accessibility of advice for all Australians.

Other advice trends

Another trend in the advice documents is the increasing number of platforms and decreasing number of strategies that advisers are recommending.

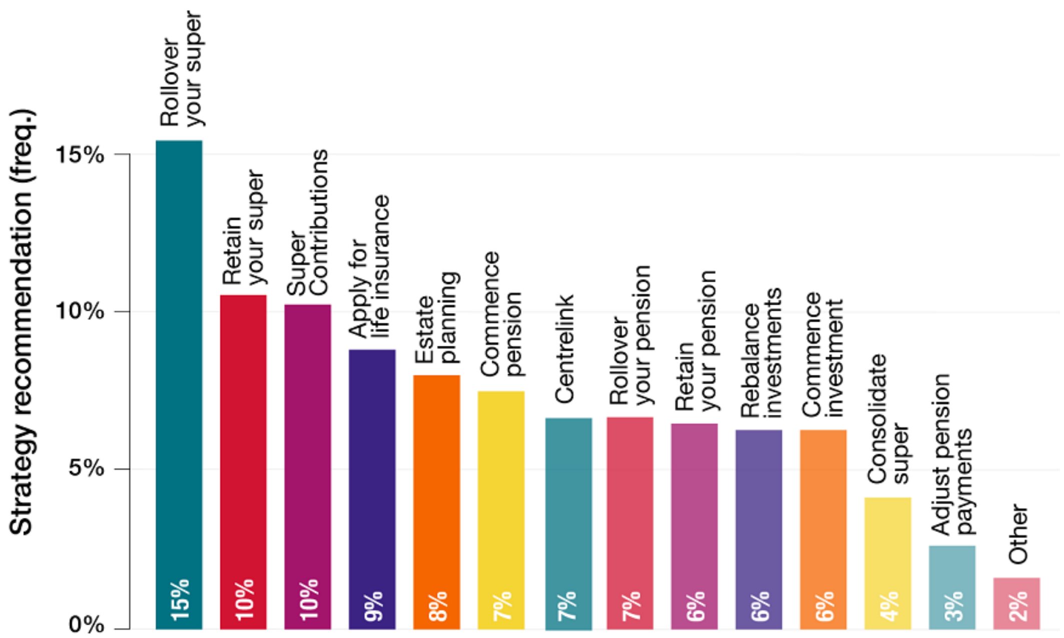
With the abolition of tied distribution and the exit of the banks and large financial institutions from the financial advice space, advisers have more freedom to recommend a larger variety of super, pension and investment platforms.

Industry super funds are becoming more adviser friendly (e.g. allowing advice fees to be deducted from a client's super balance), and hence are also increasingly being recommended. Although they are restricted somewhat by their licensee's approved product list (APL), advisers are taking advantage of the myriad of platforms available in the market and according to our data, recommending multitudes. This suggests that advisers are genuinely seeking the most appropriate platform that suits the needs of their individual clients and not recommending platforms based on a financial or other benefit, as they have been accused of doing in past years.

Within the investment space, we have seen a move away from traditional managed funds and a significant move to the use of managed discretionary accounts (MDAs), separately managed accounts (SMAs) or individually managed accounts (IMAs). These types of accounts offer several benefits for clients including direct ownership of the securities by the account owner, full transparency of the underlying securities, and resulting tax optimisation on an individual account basis.

Despite this platform trend, the number of strategies that advisers are recommending is narrowing and limited. Of the 650 plus strategies and all their various permutations that are available to advisers to use, advisers for the most part are restricting their recommendations to those that they know and admire. Without the assistance of sophisticated technology, advisers cannot possibly be abreast of all the advice strategies available or be able to link to a client's demographic to check eligibility.

Most common advice strategies



According to our data, 'rollover your super' is the most recommended strategy used by financial advisers. This is followed by 'retain your super', strategies that recommend insurances, 'review your estate planning arrangements', 'commence an account-based pension' and 'review your Centrelink entitlements'.

Strategies that recommend rolling over your pension or retaining your pension are the next most popular advisers' recommendations. Recommendations to commence an SMSF have plateaued in recent years but are more highly recommended by financial advice firms that have a connection with an accounting entity (generally due to a joint ownership structure).

Opportunities for advisers

The financial advice industry is clearly in a state of flux, but with the demand for financial advice still strong among Australians and the Government's response to the QAR due soon, there are good opportunities for financial planners. The move to use MDAs, SMAs and IMAs shows no sign of abating, and these structures will be key to the success of advisers. Combined this with the smart use of technology to develop advice strategies, this will ensure advisers can provide tailored, cost-effective advice for the benefit of their clients.

Anne-Marie Esler is Co-Founder and Co-CEO of fintech firm, Padua Solutions.

Is it the right time for Buy-Write funds?

Graham Hand

Every investment demands a compromise. The long-term upside of shares comes with short-term downside risk and a potential permanent loss of capital. Government bonds are capital secure but with lower income and they will never be worth more than par at maturity. Any number of risks can hit a property investment, even in the best of locations. In assessing these trade-offs, Buy-Write (sometimes also called covered call) funds offer a mix that may appeal to some investors in the current circumstances.

Buy-Write strategies forgo some of the potential upside in the stockmarket in exchange for enhanced income (above equity dividends). It entails buying or owning a stock or portfolio and simultaneously selling a call option against it. The investor earns extra income by retaining the premium received from writing the call. However, in giving someone else the right to buy a share at the call price, some upside potential is removed.

(The strategy is usually called a covered call if the shares are already held and the option is written against an existing portfolio. For this article, we will use the terms interchangeably).

The S&P/ASX Buy-Write Index

The ASX provides an index based on holding the S&P/ASX200 portfolio of stocks and selling (or writing) an index call option for income. The S&P/ASX Buy -Write Index (ASX: XBW) is plotted below against the usual S&P/ASX 200 accumulation index (ASX:XJO). The ASX describes the Buy-Write index in more detail here.

"In the case of the XBW, the underlying security is the S&P/ASX 200 Accumulation Index over which a S&P/ASX 200 Index call option is sold each quarter. Once an option series has been selected and a short option position established, the option position is held to expiry."

The comparison of XBW (with the option) and XJO (the normal index) using a Market Index chart shows the red line, the ASX200, outperforms the Buy-Write version, the blue line, during rising markets, and then the options strategy does well in flat or falling markets. Over the last five years, XBW has outperformed XJO.

How Buy-Write works and potential yield enhancement

The advantage of using a fund for a Buy-Write strategy is that the options and investment buying is done by the fund manager, but let's illustrate how it works using one stock. Let's say you own 1,000 Company A shares at $20 worth $20,000 and you would like more income from them, and you are not expecting the price to rise in the short term. A Buy-Write (covered call) strategy could be to sell 1,000 June 2023 $22.00 call options at $1.00, generating income of $1,000 or 5% of the value of the shares.

At expiry, the so-called 'break-even' for the strategy is a share price of $19.00 ($20 minus $1), or a fall of 5%. If the market does not change, the shares are still worth $20,000 but the gain is $1,000 for the expired option. The option holder does not exercise the right to buy at $22 because Company A is cheaper on the market.

If Company A shares rise to $25, there is an increase in value of $5,000 on the shares but a loss of $3,000 on the option, but with the $1,000 of option premium, the gain is $3,000 ($5,000-$3,000+$1,000) from holding Company A and selling the call instead of $5,000 from simply holding. This shows how Buy-Write strategies give away some of the upside in a strong market.

According to the ASX, Buy-Write options are the most common options strategy on the exchange, although the focus in this article is on the funds that adopt the technique, not individuals.

Why the timing might be right

There are many reasons why equity market returns over the next few years might not be as good as the excellent period from 2012 to 2021. This favourable time was characterised by falling and low interest rates and inflation, the rise of dominant technology stocks such as Apple, Google, Microsoft and Amazon, and the S&P500 rising a healthy 17% per annum for 10 years to 2021. The end of this period also saw generous monetary stimulus during the pandemic from central banks around the world which powered a recovery, but there is now a payback period underway.

At no time in the last decade did the world experience a war as threatening as the Ukraine conflict, in which either Russia will eventually win and continue its push westwards, or Ukraine will win, and Russia's final fling may include a nuclear threat. Global supply chains have faced realignment and future demographic changes in China, Japan and much of the west will challenge economic growth. The world faces massive costs in decarbonising with dislocations in energy supplies. Interest rates have risen quickly and bank lending standards are tightening.

Investment conditions are simply not as favourable as in the previous decade. At the latest Annual Shareholder Meeting of Berkshire Hathaway, Warren Buffett warned that the recent success of his companies after a strong growth period is now winding down, and *"The majority of our businesses will report lower earnings this year than last year."*

There are two main reasons why covered call strategies should outperform during bear markets.

First, income from selling calls partly offsets falling share prices, especially as call options are less likely to be exercised. More of the option premium is retained.

Second, volatility is usually higher during major bear markets, and premiums are larger from selling calls. The fund manager hopes the options market is overpaying for the opportunity to benefit from rising share prices.

Australian funds that use Buy-Write

Many Australian funds write call options against their portfolios to generate income, but investors should ensure the funds acknowledge two things:

- It is not a silver bullet to magically generate free income, as it gives some (perhaps most) of the upside to the options buyer.
- The fund is likely to underperform in a strong bull market. Investors should not be critical of the fund manager if this happens, assuming it is due to the structure and not poor stock selection.

Here is a sample of Australian Buy-Write funds:

1. First Sentier Equity Income Fund

First Sentier has run this strategy with the same team since 2008 and identifies three sources of income: two are the traditional streams generated from dividends and franking credits, and the third is the option premium income. In contrast to other equity income strategies, the managers do not specifically target high dividend companies, but look for the best investments including growth stocks which do not pay high dividends.

First Sentier quote the example of realestate.com (ASX:REA) which is not normally in an equity income fund because its dividend yield is only around 2%. But hidden in that number is a rapidly-growing income stream, driving a rising share price, so the income grows although the yield stays at only 2%. The income received from REA has been 40% dividends, 15% franking credits and 45% options premium. However, a bigger dividend payer such as CBA delivers income from 70% dividends, 20% franking credits and 10% options premium.

The fund outperforms in the vast majority of down months because it is collecting options premiums, but should be expected to underperform in a strongly-rising month.

This specific example provided by First Sentier comparing Telstra with Domino's Pizza shows although Telstra offered the bigger dividend yield in 2007, a much larger income stream has been achieved from the faster-growing pizza company.

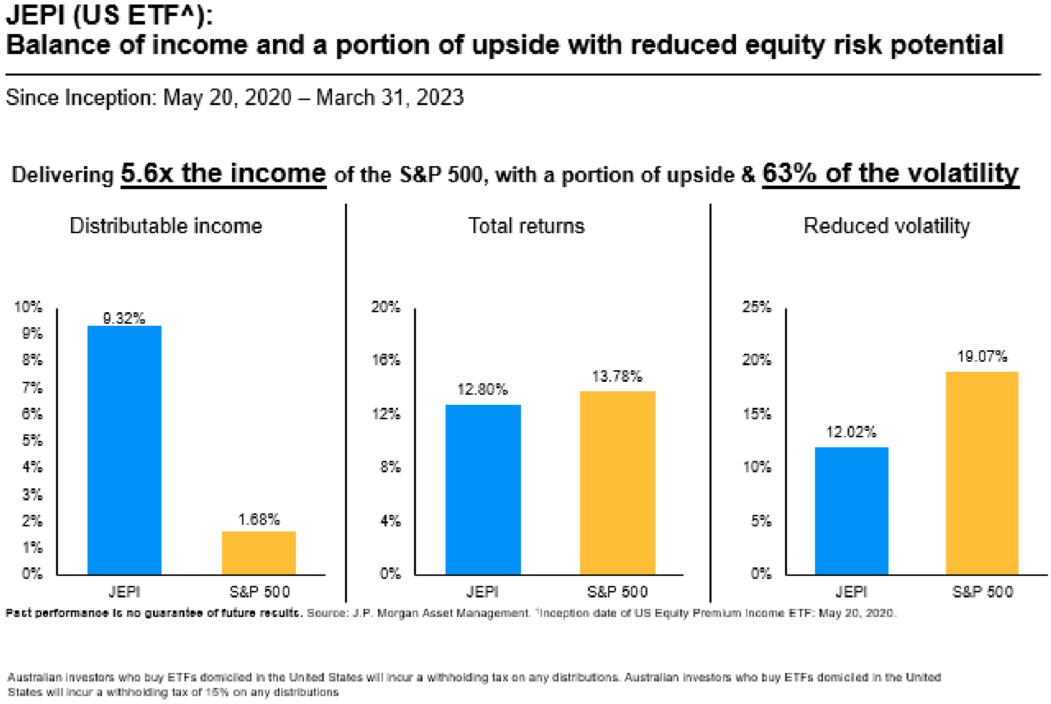
Growth of $10,000 invested in June 2007

		Telstra Corporation (TLS)	Domino's Pizza Enterprises (DMP)
June 2007	Stock price in 2007	$4.59	$3.37
	Yield in 2007	8.71%	4.51%
	Income generated over 1 year to June 2007	$871	$451
June 2022	Value of holding in 2022	$8,388	$202,046
	Stock price in 2022	$3.85	$68.00
	Yield in 2022	6.08%	1.87%
	Income generated over 1 year to June 2022	$498	$6,702
Total income generated over 2007–2022		$11,889	$38,902

2. JP Morgan Equity Premium Income

The JP Morgan Equity Premium Income ETF (ASX:JEPI) is an Australian-listed version of the largest actively-managed ETF in the US, with assets over US$24 billion. It delivers regular income and exposure to the S&P500 with lower volatility. It sells one-month, out-of-the-money call options to generate income but JP Morgan is clear that it may forgo some of the market's upside.

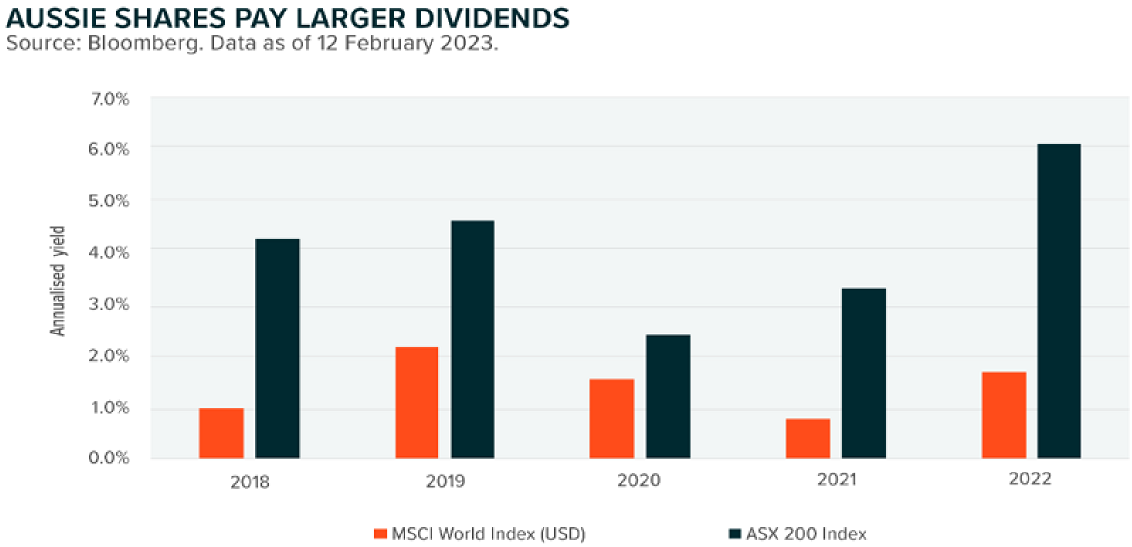
This chart from JP Morgan Asset Management shows how much of the distributable income on the US funds relies on the options value. Typical of covered call funds in a rising market, its total returns are less than the S&P500 as it misses some of the upside, but with significantly less volatility.



3. Global X Covered Call ETFs

ETF issuer Global X has introduced a range of covered call funds to the local market including the Global X S&P/ASX 200 Covered Call ETF (ASX:AYLD). The fund holds the companies in the S&P/ASX 200 index and sells at-the-money call options on the same index on a quarterly basis to generate income. It aims to track the performance of the S&P/ASX Buy-Write Index as described above. Australian investors also have access on local exchanges to the Global X Nasdaq 100 Covered Call ETF (ASX:QYLD) and Global X S&P 500 Covered Call ETF (ASX:UYLD) which are among the largest covered call strategies in the world.

Generally, Australian Buy-Write funds do not rely on selling options for as much of their income because Australian companies pay higher dividends than US companies.



Other funds may use a range of strategies designed to generate multiple sources of return, such as the Talaria Global Equity Fund (Managed Fund) (ASX:TLRA) which is part of the Cboe stable of funds. It uses various options techniques including Buy-Write, and the call option is always fully equity backed so there is no added leverage from the options position. The Betashares Yield Maximiser ETF (ASX:YMAX) also uses Buy-Write.

Buy-Write suitability for particular investors and markets

A Buy-Write fund is not a typical equity fund which gives exposure to the stockmarket and its returns rise and fall directly with the market and the ability of a fund manager to select stocks. Rather, it comes with a particular investment proposition that may not capture all the market upside in return for collecting options premiums. The strategy will tend to outperformance in flat or falling markets but not in strongly-rising markets.

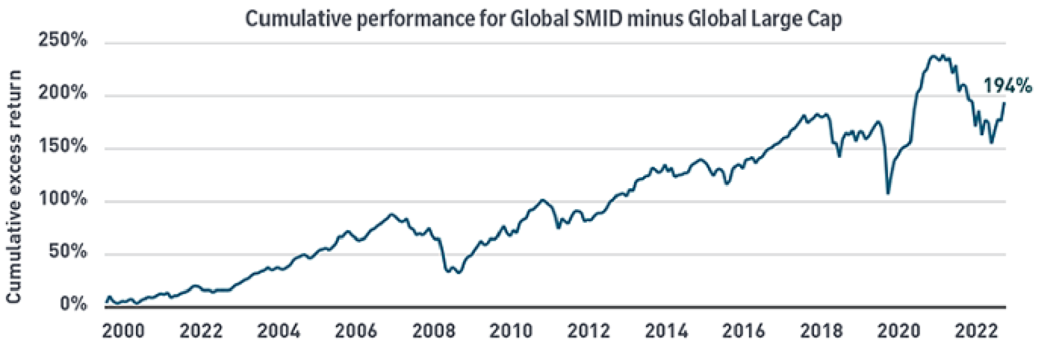
Graham Hand is Editor-At-Large for Firstlinks. This article is general information and does not consider the circumstances of any investor. The strategy offered by the funds mentioned in this article involve using options which may be more difficult for some investors to understand, and financial advice may be warranted.

The cheapest small cap valuations in decades

Nicholas Paul

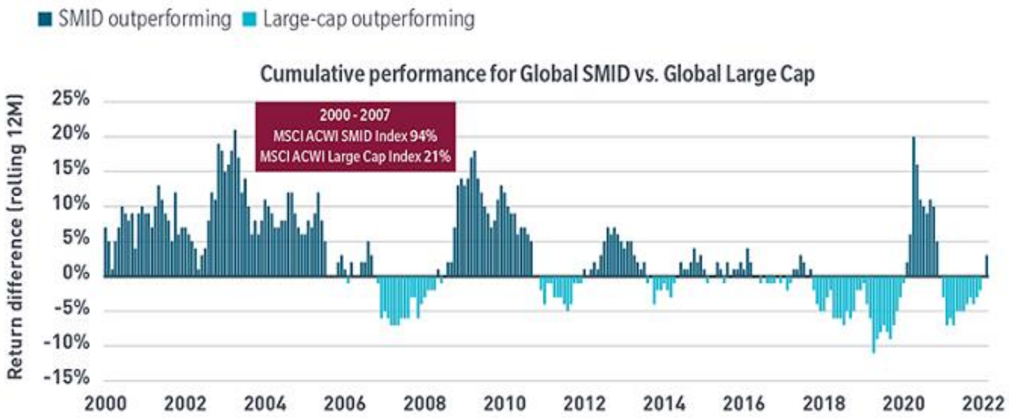
The global small- and mid-sized (capitalisation or cap) asset class (SMID) has strongly outperformed large-cap stocks over the long term, and while market leadership ebbs and flows over shorter periods, SMID appears well-positioned to potentially assume a leadership role over the next few years.

Exhibit 1: Global small/mid-cap stocks have strongly outperformed large-caps over time



Source: FactSet. Monthly data as of 31 December 1999 to 31 January 2023. Series shows the cumulative excess returns for MSCI All-Country World SMID Index (ACWI SMID) minus MSCI ACWI Large Cap Index (ACWI Large). Total returns are gross and in US dollars. Past performance is no guarantee of results. It is not possible to invest directly in an index.

Exhibit 2: While leadership has tended to rotate every few years



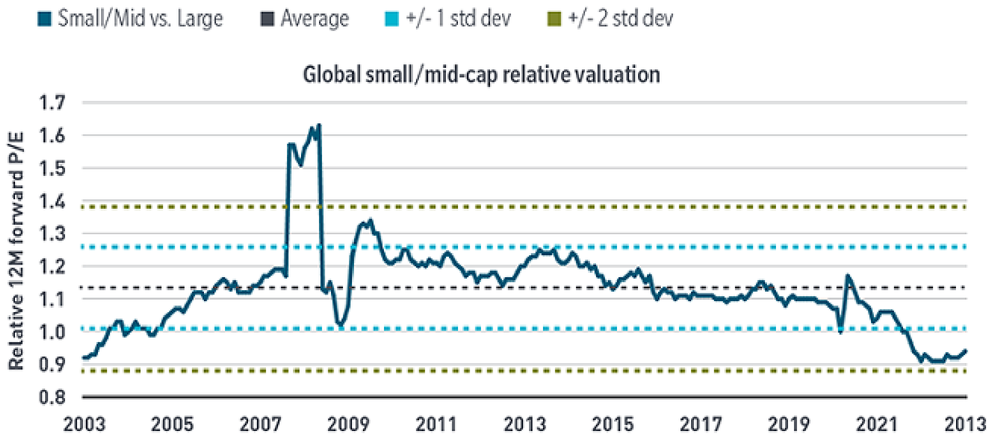
Source: FactSet. Monthly data as of 31 December 1999 to 31 January 2023. Series shows the rolling 12-month excess returns for MSCI All-Country World SMID Index (SMID) relative to MSCI All-Country World Large Cap Index (Large-cap). Total returns are gross and in US dollars.

Why consider investing now?

In our view, the opportunity set for small- and mid-caps appears particularly attractive. Referring back to Exhibit 2, from the end of the dot-com-era (early 2000s) until the early days of the GFC in 2008, global small- and mid-cap stocks significantly outperformed relative to their large-cap counterparts. The MSCI ACWI (All Countries World) SMID Index returning 94% vs. the MSCI ACWI Large Cap Index return of just 21%.

And while no two periods are perfectly alike, there are similarities between that roughly eight-year period from the early to late 2000s to today’s environment. First, valuations offer investors a buying opportunity not seen in decades, as valuations are close to two standard deviations 'cheap' relative to large caps.

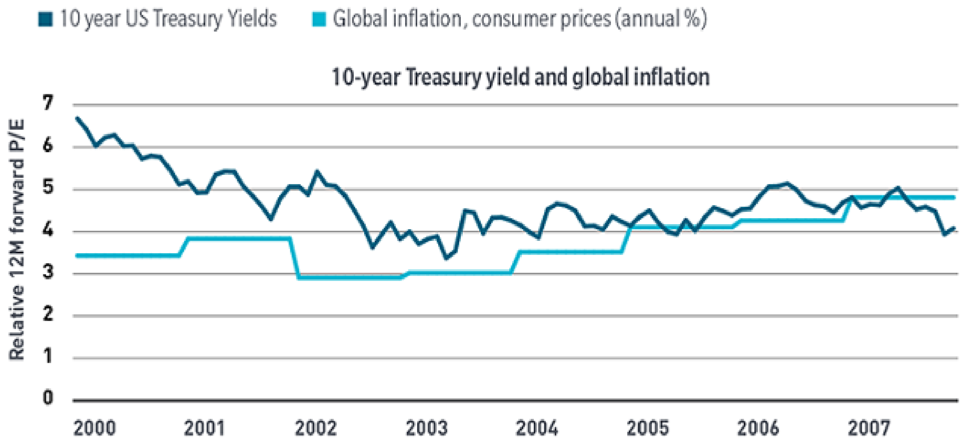
Exhibit 3: Global small/mid-cap valuations at multi-decade lows relative to large-caps



Source: FactSet. Monthly data as of 31 January 2003 to 31 January 2023. Series shows the relative forward price-to-earnings for MSCI All-Country World SMID Index (ACWI SMID) relative to MSCI All-Country World Large Cap Index (ACWI Large).

Second, inflation and interest rates during the run up to the GFC are more aligned with today's reality versus what we witnessed in the decade following the GFC to the culmination of the pandemic. At that time, inflation was essentially non-existent and globally yields were either close to zero or even in negative territory. In fact, from 2000 through the end of 2007, the 10-year US Treasury yield averaged 4.7% and global inflation averaged 3.7% (Exhibit 4). That period is not all that different from today.

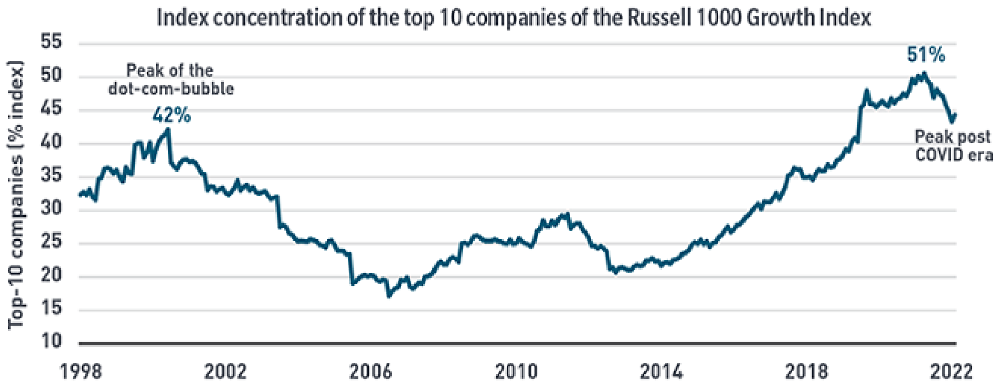
Exhibit 4: 2000 – 2007: Inflation and interest rates more reminiscent of today's environment



Source: FactSet for 10-year US Treasury Yield. Monthly data as of 31 January 2000 to 31 December 2007. Global Inflation, consumer prices (annual %) - World Development Indicators. Data from database: World Development Indicators. Annual data from 2000 – 2007.

Markets during the pre-GFC period also witnessed a dramatic sell-off as the dot.com bubble burst. The high-flying technology stocks with unattainable growth expectations - think irrational exuberance - of that period are analogous to the meme stocks of today. Looking at the concentration of the Russell 1000 Growth Index at the end of 2001, similarities are again apparent (Exhibit 5).

Exhibit 5: A handful of large-cap stocks dominated performance then and now

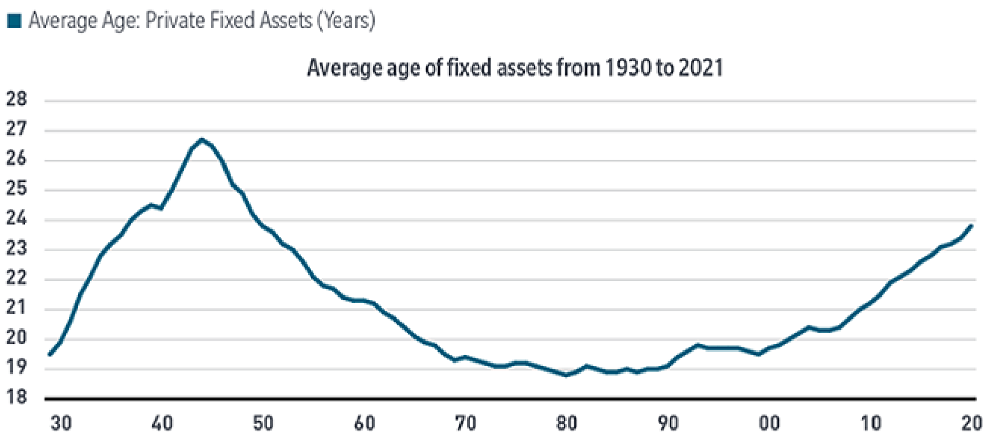


Source: FactSet. Monthly data as of 31 December 1998 to 31 January 2023. Past performance is no guarantee of results. It is not possible to invest directly in an index.

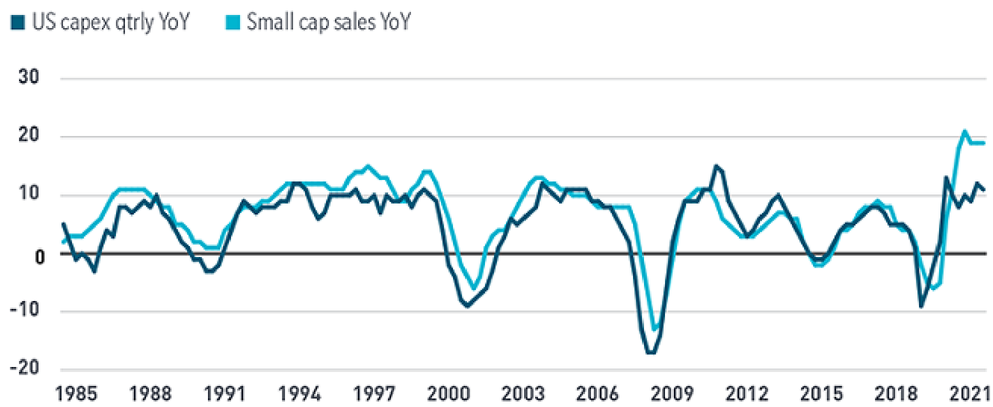
Future spending trends may benefit a wider cohort of sectors and industries, including small- and mid-cap stocks, rather than just the mega-cap technology companies that garnered the dominant share of spending in the past decade. Specific to SMID, spending trends may be driven by a 70-year high in the average age of fixed assets (see Exhibit 6).

Further, a move to localisation as governments and companies around the world onshore supply chains to improve their supply chain resilience could provide a tail-wind. The local nature of small- and mid-cap companies could work in their favour while large-cap company margins may come under pressure as benefits of globalisation (lower taxes and labour costs) subside as onshoring gears up.

Exhibit 6: Small/mid-caps may benefit as aging fixed assets may drive capex which has been highly correlated with sales growth



Source: Haver Analytics, Bureau of Economic Analysis, Goldman Sachs Global Investment Research from 31 December 1930 to 31 December 2021.



Source: FactSet, Haver Analytics, BofA US Equity & US Quant Strategy. Monthly data as of 31 December 1985 to 31 December 2022.

The strong performance of a handful of major US technology stocks during the past decade means today's global investor is significantly less able to gain exposure to small- and mid-cap stocks through the traditional standard global benchmark allocation. In our view, the dominance of the most influential large-cap stocks can be better appreciated when viewed from the perspective of market-capitalisation buckets, as illustrated in Exhibit 7, where exposure to small- and mid-cap stocks in the MSCI World Index has declined from 43% of that index in 2010 to only 22%.

We witness an almost identical trend in the MSCI All Country Index, where small- and mid-cap stocks declined from 46% of the index to just 26%.

Exhibit 7: Changing landscape of global large cap benchmarks

	MSCI All Country \ World Index	MSCI World Index
Small-Mid Cap Exposure 12/31/10	45%	43%
Small-Mid Cap Exposure 12/31/22	26%	22%

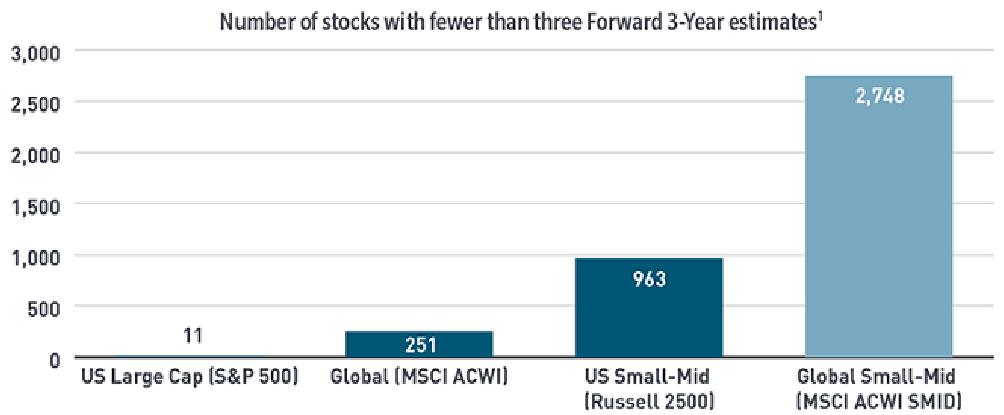
		31-Dec-10	30-Sep-22	Change	Market Cap Segmentation
Market Cap – MSCI All Country World Index	Up to $30bn	45.49	25.69	**-44%**	**Small-Mid Cap**
	$30bn - $300bn	53.16	52.34	-2%	Large Cap
	Over $300bn	1.35	21.96	**1527%**	**Mega Cap**
Market Cap – MSCI World Index	Up to $30bn	42.88	22.48	**-48%**	**Small-Mid Cap**
	$30bn - $300bn	55.60	54.11	-3%	Large Cap
	Over $300bn	1.53	23.41	**1430%**	**Mega Cap**

Source: MFS Research 31 December 2022.

Why active management?

We believe this asset class may present more outperfromance (alpha) opportunity for active managers. The universe receives substantially less research coverage by sell-side analysts compared with other asset classes, particularly large-cap stocks (Exhibit 8). The return dispersion for these stocks is more than double that of large-caps (Exhibit 9). Both of these factors present ample opportunity for active managers with the experience and deep research resources to identify attractive stock opportunities.

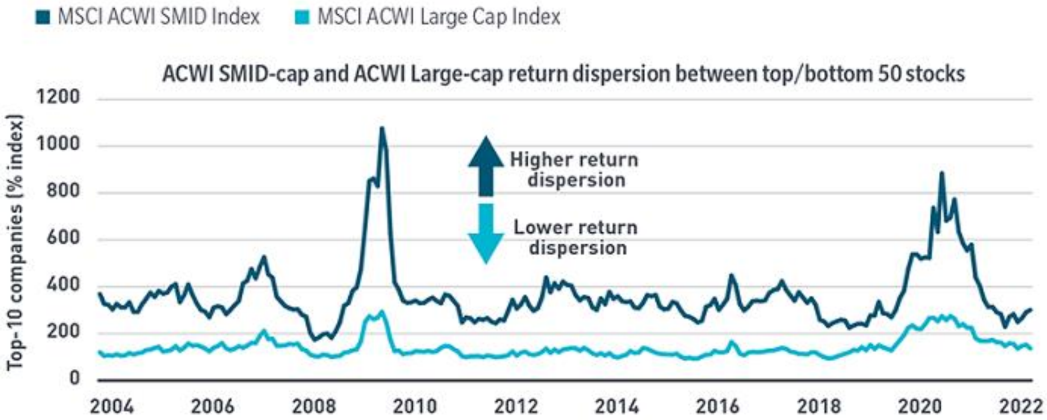
Exhibit 8: Lack of research coverage may offer opportunity for active managers with a global research platform



Source: FactSet data as of 31 December 2022, latest data available.

[1] Estimate counts and averages are based on the number of I/B/E/S (Institutional Brokers Estimates System) earnings estimates reported for the 3rd fiscal year forward as of 31 December 2022.

Exhibit 9: Higher dispersion for global small/mid-cap may present more alpha opportunity for active managers



Source: FactSet Portfolio Analysis. Monthly data as of 30 July 2004 to 31 December 2022 for MSCI ACWI Large Cap Index and MSCI ACWI SMID Index. Return dispersion is based on underlying stock returns for the best (top 50) and worst (bottom 50) performing stocks on a trailing 12-month basis. Buckets are constructed each month for the Top 50 and Bottom 50 returning stocks based on their trailing 12-month return. A simple average of their returns is used each month to calculate the Top-50 and Bottom-50 group's return for each index.

Nicholas J. Paul, CFA is an Institutional Portfolio Manager at [MFS Investment Management](). This article is for general informational purposes only and should not be considered investment advice or a recommendation to invest in any security or to adopt any investment strategy. Comments, opinions and analysis are rendered as of the date given and may change without notice due to market conditions and other factors. This article is issued in Australia by MFS International Australia Pty Ltd (ABN 68 607 579 537, AFSL 485343), a sponsor of Firstlinks.

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Stocks are less risky than bonds in the long term

Andrew Mitchell

OK, we admit. That headline was to draw you in. But it is correct, with one tiny caveat: 'in the long run'. At least that's what the data shows, as we'll explain in this article.

Stocks versus bonds is a vital question given the rise in bond yields and interest rates in most major markets over the last 18 months.

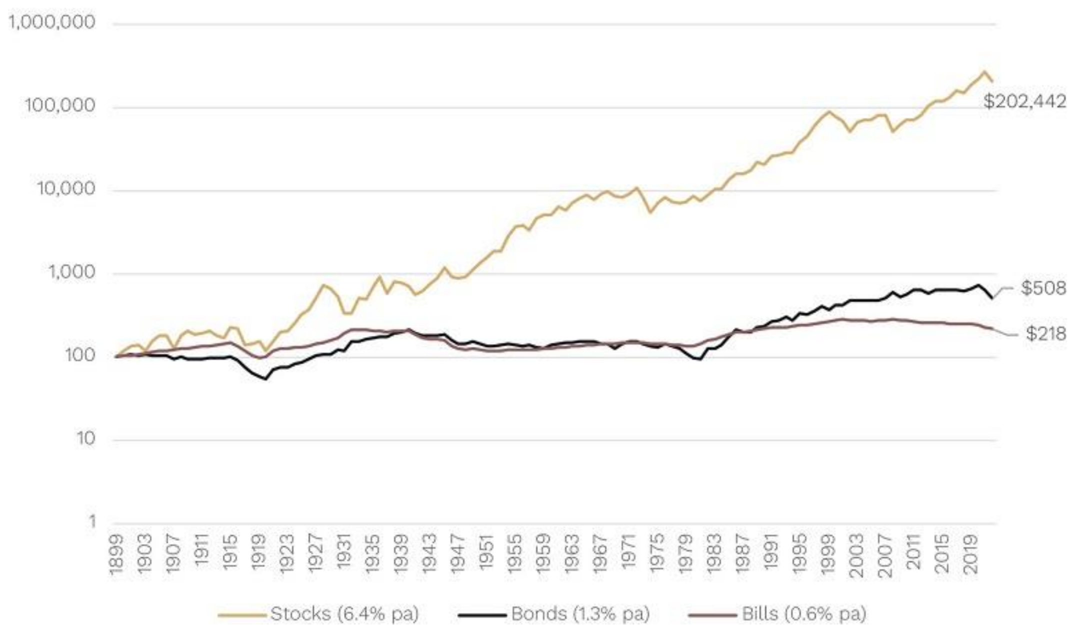
We have gone from a TINA (There Is No Alternative) investing environment where shares were often seen as the only game in town when interest rates were near zero to a TIARA investing world (There Is A Reasonable Alternative) where bond yields have become more attractive.

While investors may be tempted by 'less risky' bonds, it's vital to understand the long-term picture. A sudden shift into bonds could dent an investor's ability to build long-term wealth and protect against inflation if that is their goal.

Wow factor

If you've read enough investment articles over the years, you have probably come across a long-term returns chart like the one below.

United States: Cumulative Growth of $100 (real terms)



Source: Cambridge Decades of Data, Factset, Ophir. Data from 1 January 1900 to 31 December 2022.

The chart shows how much a US$100 investment in year 1900 (the equivalent of about US$4,000 in today's dollars) would have grown to by the end of 2022 if you'd invested in U.S. stocks, bonds or bills (you can also think of bills as short-term term deposits for those in Australia).

Here we show it in 'real' terms, that is after inflation, because without doing so the numbers start to look nonsensical. And ultimately over long periods of time what investors generally care most about is how much their purchasing power (wealth increases above inflation) has grown.

We've also shown it with a 'log' vertical axis because again, if we don't it would look crazy as you would barely be able to see the bonds and bills lines given how much shares won by.

The main takeaway from these charts is usually: 'Wow! It's insane how much shares have outperformed over the very long term'.

Dramatically less risky

The difficulty many investors have though sticking with shares is they can be volatile/risky/a rollercoaster over the short term.

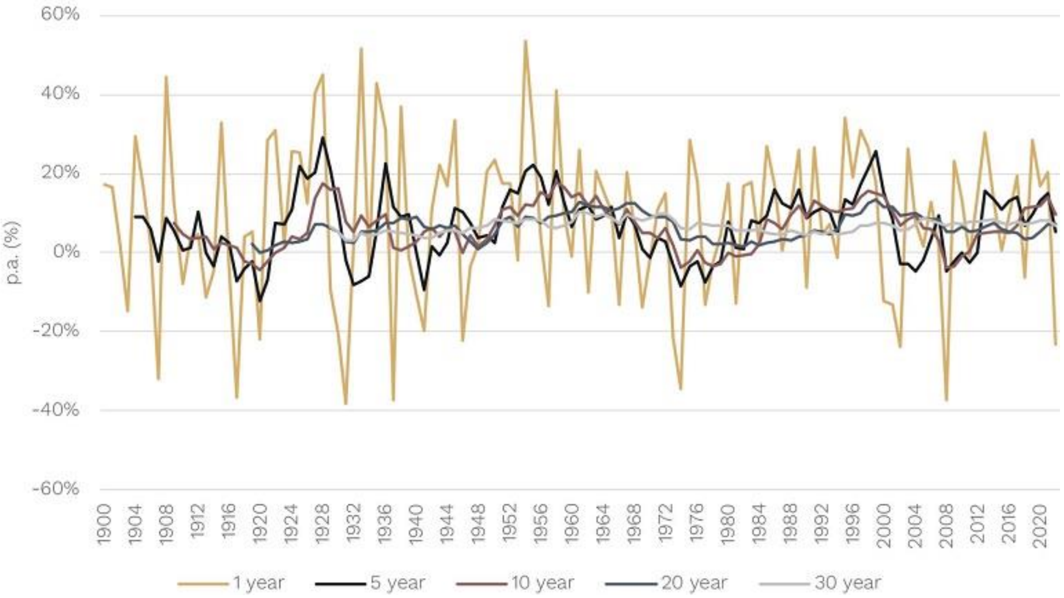
In this next chart, the gold lines show the real annual returns for the U.S. share market since 1900. They are all over the place. The fact the vertical axis has to go from -60% to +60% to fit the returns in should give you some idea of the wild year-to-year ride.

However, we've also shown the rolling 5, 10, 20 and 30 year per annum returns in the other lines. The ride becomes a lot less volatile as you move out to longer time horizons.

At 10-year horizons, negative real returns become quite rare. And at 20+ year horizons they disappear completely (historically investors have never lost money in real terms for investing periods of 20 years or more in U.S. shares).

The chances of losing money in the share market has tended to become DRAMATICALLY smaller the longer you are invested.

USA: Real Holding Period Returns – Shares

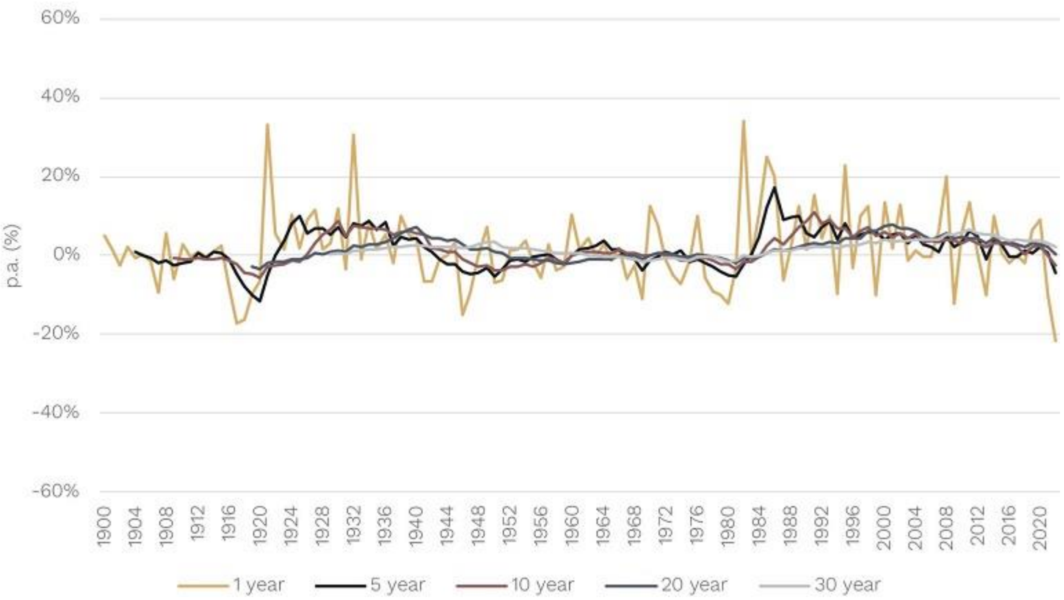


Source: Cambridge Decades of Data, Factset, Ophir. Data from 1 January 1900 to 31 December 2022.

Positively placid

How does this compare to U.S. bonds, which are once again tempting us with their yields, you may ask? Using the same sized vertical axis, below you can see that annual U.S. bond returns are nowhere near the same roller coaster ride as shares.

USA: Real Holding Period Returns – Bonds



Source: Cambridge Decades of Data, Factset, Ophir. Data from 1 January 1900 to 31 December 2022.

Yes, they can toss you around a little every now and then, but the ride is way less stomach churning and not really going to turn you upside down and have your money fall out of your pockets.

(Note 2022 was one of the exceptions when long-term bond yields increased materially (bond prices declined) *and* you had high unanticipated inflation producing the largest negative real annual return over this 123-year period!).

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Like shares, though, when you move to longer investment horizons, the ride becomes less bumpy and positively placid at 20+ years.

The importance of time horizon

But at longer investment horizons, like 10 or 20+ years, are shares still riskier than bonds? This is a crucial question.

That time horizon is the bare minimum horizon for most investors saving for their retirement.

(Some investors might argue that a 20+ time horizon is way too long. But many, particularly those in accumulation phase, have horizons of 40-50 years, and up to 60 years if you include retirement. Even a retiree at 67 who lives well into their 90s, increasingly common as we live longer, has a horizon of way more than 20 years.)

Yet many investors let year-to-year movements in different asset classes like shares and bonds determine their longer-term allocations.

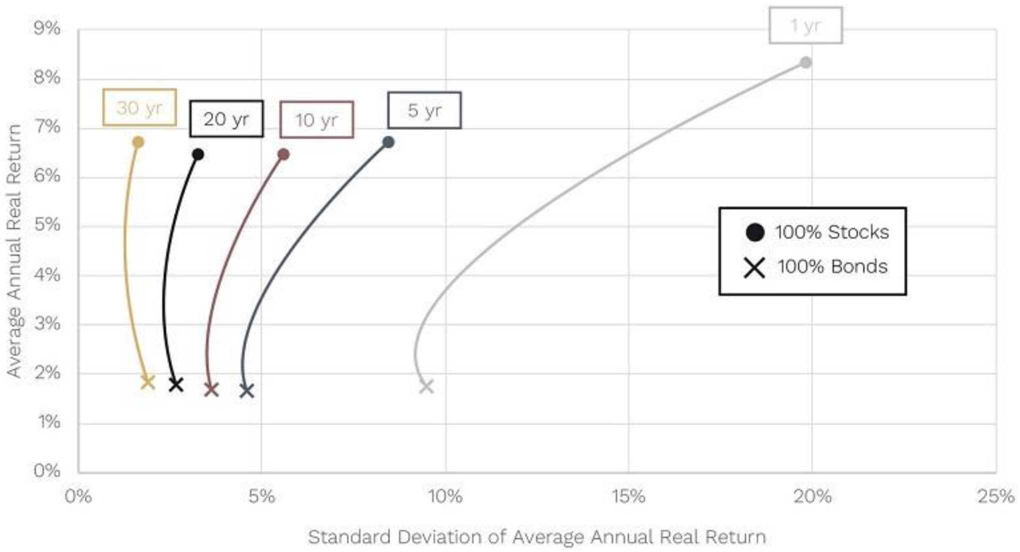
The risk of doing that is potentially missing out on the power of equities to grow and protect wealth from inflation over the long term.

The greatest investment chart

This leads us to what is without doubt our favourite investment chart of all time. Our favourite mostly because it upends that 'lesson' from Investing 101: that risk is always related to return … and the riskier an investment, the higher return it should provide you.

It underpins one of the most commonly held assumptions about investing: that stocks are riskier than bonds.

U.S. Equities & Bonds: Risk-Return Trade-Off for Various Holding Periods, 1900-2022



Source: Cambridge Decades of Data, Factset, Ophir. Data from 1 January 1900 to 31 December 2022.

They certainly have tended to provide higher long-term returns. Just see our first chart. And they certainly look riskier over the short term. Just see our second and third chart. But are they riskier over the long term?

Now our favourite chart takes a little explaining. But buckle in because its lesson is worth the effort. It's a lesson that in our experience many seasoned professionals haven't even heard or seen of before.

The previous chart shows the average real (after inflation) returns for portfolio mixes of U.S. shares and U.S. bonds on the vertical axis over different holding periods (rolling one year to rolling 30 year) since 1900.

Using standard deviation as a measure of volatility, it also shows the range of outcomes around the average – or how risky – each portfolio is for each holding period on the horizontal axis.

As you can see, as you move down each line (from top to bottom) and progressively add more bonds to your portfolio, average portfolio returns decline.

Nirvana

Historically, a 100% U.S. stock portfolio is way riskier than 100% U.S. bond portfolios over holding periods of one year. A no brainer here – stock returns move around a lot more than bond returns over the short term, as we saw earlier. But here is where it gets interesting.

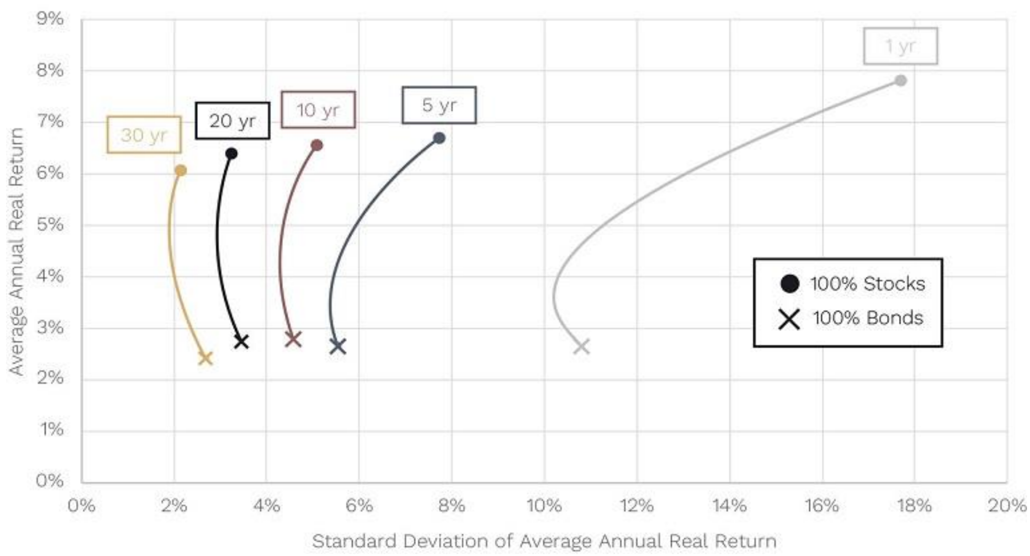
Historically as your holding period has moved from one year out to 30 years, the riskiness of a 100% U.S. stock portfolio has radically decreased such that by the time you reach a 30-year holding period we enter nirvana.

At 30 years, stocks have earned higher average real returns than bonds (and by a lot we might add!) … but they are also less risky!

Incredible.

This outcome also holds for the Australian share market, as you can see in the chart below. In fact, in Australia, stocks become less risky than bonds at even shorter horizons. By the time you reach a 20-year horizon, stocks are less risky.

Australian Equities & Bonds: Risk-Return Trade-Off for Various Holding Periods, 1911-2022



Source: Cambridge Decades of Data, Factset, Ophir. Data from 1 January 1911 to 31 December 2022.

The prize of patience

Investors only considering the short term may be lured by the siren call of 'less risky' bonds. That lure is becoming stronger now that bond yields have become more attractive. But, as we've discussed, investors' time horizons are much longer than many may think.

To reach their investment and retirement lifestyle objectives, long term investors need exposure to the superior long-term returns of shares.

Shares have also tended to be a good long-term inflation hedge due to the ability of companies to pass on price increases. But bonds have a mixed record here and your purchasing power can get crushed during periods of unanticipated inflation that exceeds the fixed levels of income it provides (just see 2022!).

The good news is shares not only deliver superior wealth building and inflation protection, but history suggests they have also been less risky over longer time horizons. It's a powerful combination for the patient investor.

To the victor go the spoils … if only investors can resist getting worried out of the market by the short-term volatility of shares.

As Warren Buffett once wisely said:

"The sharemarket is a device for transferring money from the impatient to the patient."

Andrew Mitchell is Director and Senior Portfolio Manager at *Ophir Asset Management*, a sponsor of Firstlinks. *This article is general information and does not consider the circumstances of any investor. Notes on return sources can be viewed via the original article here.*

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Aggressive climate targets spell opportunity for investors

James Tsinidis

Most countries are on a net-zero emissions crusade. Whether the goal is 2050 or later, there is no escaping the global push to reduce carbon emissions and combat climate change.

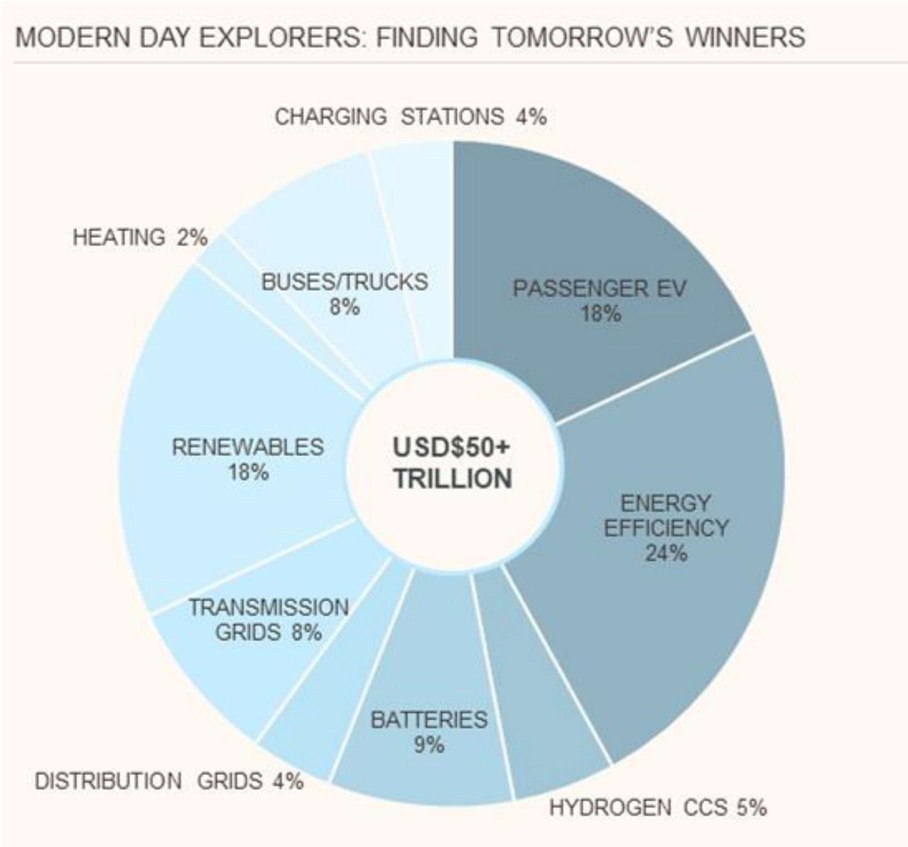
This transition presents a huge opportunity for investors to invest in those companies building or adapting the technology and infrastructure to reach this target. We believe there is $US50 trillion to be spent over the next 30 years in this transition across a diverse range of industries and companies.

The potential

As the chart below highlights, investment will not just be on passenger electric vehicles (EVs), but also on the infrastructure - such as charging stations - needed to support EVs. Likewise, investment also needs to be made in energy efficiency, renewable energy, battery manufacturers and the power grids to support the transition.

Ultimately this will translate to $US50 trillion in revenue to the companies that are going to enable the transition.

Figure 1: This is how much de-carbonisation is going to cost



Source: Goldman Sachs, Munro Partners Estimates (31 December 2020)

At Munro, we've been investing in this space for 15 years, but in the last few years we've seen momentum shift to the point where there is consensus around the need to decarbonize the planet.

Our focus is to find the solution providers for this transition. We seek to invest in these enablers because they are the companies positioned to secure the spending and therefore revenue, which will ultimately lead to earnings and share price growth.

The year ahead - three themes

1. EV penetration

EV penetration is accelerating for a number of reasons. Manufacturers have been cutting prices and Tesla is leading the market with price drops of between 15-29% in the US.

Importantly, the US's Inflation Reduction Act included a potential $7,500 tax credit for Americans cars that qualify, bringing the EVs in reach of many more potential consumers.

At the same time as price reductions, input costs for EVs are also decreasing. Lithium is down close to 70% from its peak, freight costs are also down, as are many other raw materials needed to manufacture these vehicles.

2. Gridlock

'Electrify everything' is an easy catchphrase but there is a potential bottleneck to this process when it comes to grid capacity and capability. Power grids need to be able to cope with the extra power that is being put on them. Whilst the grid is a solution to climate change because it enables electric vehicles and other things to be electrified, the grid itself is actually at risk because of climate change.

If we look at the US, 70% of the grid is now over 25 years old. Electricity demand is going to nearly triple by 2050 and grids need to be able to work in a more bi-directional way than they did historically. To do this, money needs to be spent on their development and advancement, an issue we believe is going to come to a head this year.

3. Globalisation reversing

Recent geopolitical conflict and tensions have put a question mark over the last 30 years of globalisation. This was highlighted with Russia's invasion of the Ukraine, when Europe quickly realised that the question of energy security and decarbonisation were more aligned than they originally thought.

China is also one of the main manufacturers of many of the components in solar panels and has increased its penetration in the production of these components over the past decade. As the geopolitical tensions between the China and the West intensifies, there are opportunities for companies to offer solutions to their governments around that industrial base to enable countries to continue that decarbonisation journey in a more self-sufficient way. This should help US and European companies in the clean energy space compete domestically after decades of losing share to China.

Under the hood - Waste Management

Recently we were asked why, if there is so much potential for growth, is the market not pricing transition companies accordingly. We believe that is because the market continues to price the companies we seek out - i.e., the solution providers - on what they are doing currently instead of what they could do in the future.

A good example of this is the waste management space and Texas-based Waste Management, the largest solid waste management company in the US.

The market models Waste Management on its traditional business, which is going around the homes in the US and picking up the trash, sorting it and then sending it to landfill. It owns the landfill sites, the trucks, the transfer stations, and gets paid well for the services it offers. It's a good defensive company in a sector with high barriers to entry.

What the market is unable to currently price for because it's a new opportunity, is the increased EBITDA it can get from expanding into two new areas. The first one is recycling, which the US has been very poor at. The company is now putting in automation to be able to generate revenues from this recycling opportunity by selling the product back to consumer companies. But Wall Street analysts are not taking this into account yet because it's not yet visible in the next 1-2 years.

Figure 2: Waste Management

Source: Bloomberg Finance L.P 24 April 2023

The other, even larger opportunity is the Landfill Gas To Energy (LFGTE) potential. Waste Management is trying to capture the renewable natural gas off its landfill sites and sell that back to other companies or use it in its own fleets.

These two activities offer a material upside to the EBITDA estimates in the market, which we predict are 10-15% too low versus what the company could generate 5 years out.

Hiding in plain sight

By looking beyond the headlines and delving deeper into some of the newer technologies that companies are exploring, investors can buy before share prices of many of these businesses take off.

James Tsinidis is a Partner and Portfolio Manager with [Munro Partners](), a specialist investment manager partner of GSFM Funds Management. GSFM is a sponsor of Firstlinks. Munro Partners may have holdings in the companies mentioned in this article. This article contains general information only and has been prepared without taking account of the objectives, financial situation or needs of individuals.

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One edge that individual investors have over fund managers

James Gruber

Here's the edge for individual investors: fund managers have clients, individual investors don't.

Fund managers sometimes consciously and subconsciously cater to their perceptions of client needs. If they don't, they won't receive money to set up a fund or keep money invested in the fund. Examples include:

1. Clients can be impatient and want returns *now,* not in three years' time. That makes it difficult for funds to pursue a long-term strategy.

2. Clients can prefer less controversial portfolio holdings. For example, ESG-friendly companies are an easier sell than coal companies, yet it can come at the expense of returns.

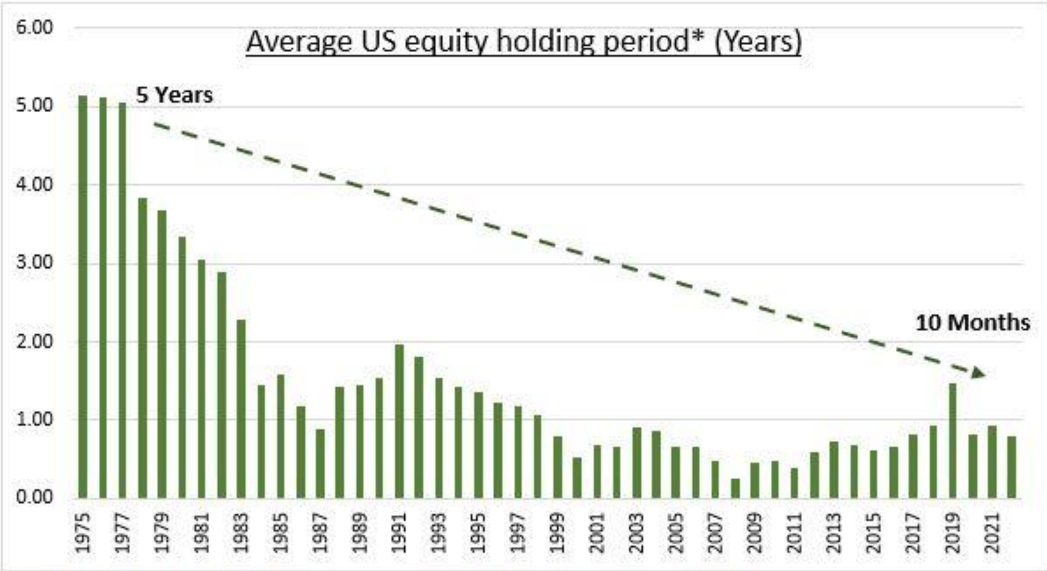
3. Clients will generally prefer less volatile, diversified portfolios. That may mean owning a company that goes up 3x, but having to reduce the holding so a portfolio doesn't become too concentrated in one stock, perhaps to the detriment of both the portfolio and the client.

Individual investors don't have these constraints, and it can give opportunities to outperform the market.

Playing the long game

The pressure for funds to perform is constant, and much of that pressure comes from clients. Clients may be able to sit through 12 months of underperformance, but if it drags through to two years, serious questions are likely to be asked. It's a rare client that will sit tight through three years or more of fund underperformance.

Inevitably, that can make funds focus on short-term performance, and the data supports this. The average holding period for stocks in the US is just 10 months.



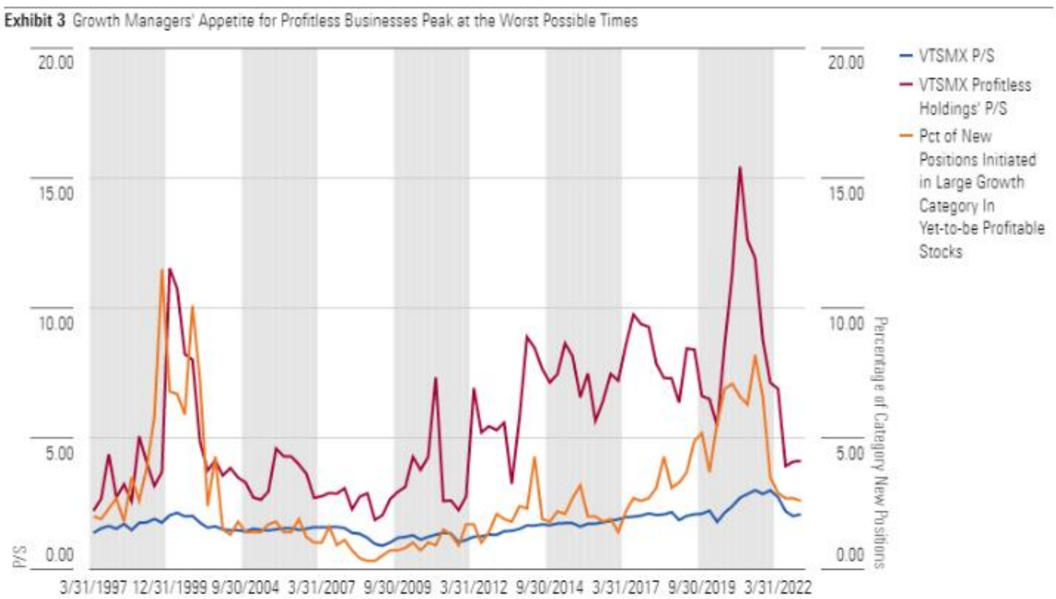
Source: WFE, IMF. *NYSE and NASDAQ market capitalisation divided by total turnover value

This holding period is for all investors, retail and institutional. Though institutional fund managers aren't much different. The average turnover rate for large-cap funds in the US is 73%. That means 73% of their portfolios are turned over each year. Or put another way, the average period that these funds will hold a stock is about 16 months. The focus on short-term performance means funds can sometimes chase momentum stocks, or those that are rising in price. This can lead to disastrous results.

In a [recent study](), Morningstar found that US fund managers loaded up on high-flying companies, many of which were profitless, during the pandemic boom of 2020-2021. And many of these managers got wiped out in the market downturn of 2022.

The study suggests that by the end of 2020, the US stock market's profitless companies were more expensive than at the tech bubble's peak and more than 8x as pricey as their profitable peers.

Yet fund managers still bought these stocks. By June 2021, about one in every 12 new positions of funds in the 'large-growth' category (those investing in growth stocks) were in unprofitable stocks. Three months later, nearly 4.5% of large-growth category assets were invested in companies that had never turned a profit. That compared to the peak of the dot-com



bubble, when 4.4% of category assets were in yet-to-be-profitable companies.

While time is often the enemy of the fund manager, it can a friend to the individual investor. In fact, it can be the individual investor's edge in the market.

Going where funds won't go

For equity funds to be marketable to clients, they'll sometimes have to stay away from stocks that are controversial. A recent example is the push for fund managers to invest in ESG-friendly companies.

From 2017, there was growing pressure on funds to remove coal companies from their portfolios. That not only led to an initial downturn in the stock prices of coal companies but starved these companies of capital to invest in new and existing coalfields. It resulted in a downturn in coal supply at a time when coal demand was still growing. The supply shortage led to a spike in coal prices and an enormous run-up in coal stocks that only ended about six months ago.

Many fund managers were constrained from holding onto coal stocks, or from buying into them. Because of this, they missed out on the staggering out-performance of these stocks during 2019-2021.

Another example comes from highly indebted companies. Funds will often explicitly say that they don't invest in companies that are highly leveraged. For instance, they may choose to not invest in stocks with a total debt to equity ratio of greater than 50%.

This can be a sensible strategy because indebted companies can bring more risk, especially during a rising interest rate environment. On the flip side, it also means that the strategy excludes a lot of companies, some of which may not be as risky as they first appear. And that can be an opportunity for savvy individual investors.

The well-known US-based investor Mohnish Pabrai gives a good example of this in his book, *The Dhandho Investor.* In 2000, Pabrai invested in a US funeral services business, Stewart Enterprises, whose stock had slumped more than 90% from its peak. The company had bought many other funeral services businesses (a roll-up business model) and taken on a huge amount of debt. The market was pricing the stock as if it was about to go bankrupt.

Pabrai saw that bankruptcy was possible, but also that the business was making good money, and had options to refinance its debt and sell-off some businesses to raise cash. He reasoned that the risks of bankruptcy were low, while the odds of the business getting through their bad patch were high. Soon after, the company announced that it was considering selling its businesses outside the US and the stock price took off. Pabrai doubled his money in under a year.

Where a fund manager can be constrained from investing in certain stocks and sectors, the individual investor isn't, and that can provide compelling opportunities.

Letting your winners run

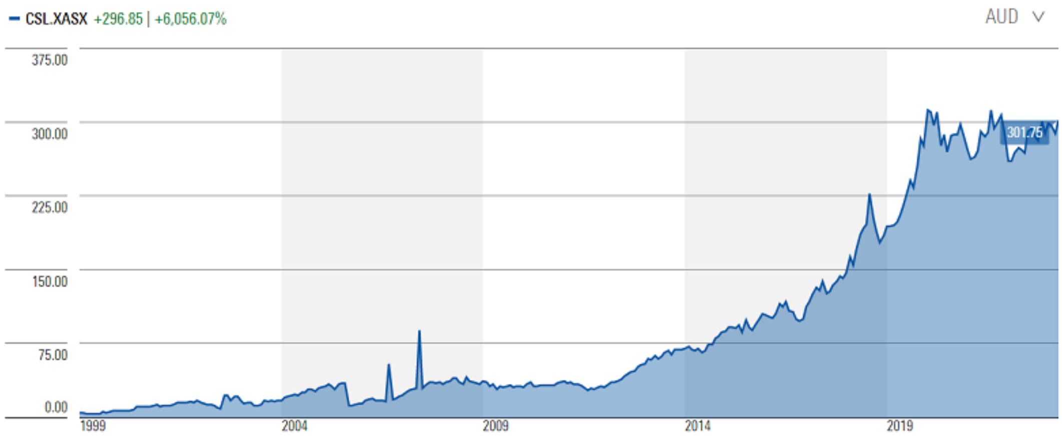
In product disclosure statements for funds, you'll regularly see statements that they won't have stock holdings exceed a certain percentage of total portfolio holdings. This is to reassure potential clients that they won't take on too much risk with one stock and that they'll be appropriately diversified.

There's nothing wrong with this, though portfolio diversification isn't a black and white topic in the world of finance. Some such as Charlie Munger think a handful of stocks is enough for a portfolio, while at the other extreme, some funds hold many hundreds of stocks.

One disadvantage of a fund having restrictions on how much of a stock they can hold is that it can mean not holding onto companies whose prices rise a lot.

For example, CSL Limited IPO'ed on the ASX at a price of $2.40 in 1994. Since then, it's risen 125x, and that's not including dividends.

Many funds bought into the CSL float yet how many have held into their original stake for the next 29 years? I don't know the answer, but I'm fairly sure that it would be none. That's because any stake in CSL from the float would have become too large within a portfolio for a fund to justify holding onto the stock.



For example, say a fund bought into CSL at the float, and the stock was 3% of the total portfolio. Given the subsequent share price rise, that 3% would have grown to perhaps 90% of the total portfolio today. What fund manager, even a successful one, could justify having CSL as 90% of their total portfolio? Invariably, clients would complain that they don't need to invest in the fund as they can hold CSL directly themselves. Or they would point to the risks in having so much portfolio exposure to just one stock.

Yet, here's a question: would have cutting back on a stake in CSL held from IPO been the right call at any time over the past 29 years? People will have different opinions on this and there's no right answer. The point is that funds are limited in how much of a stock they can own in portfolios.

James Gruber is an Assistant Editor for Firstlinks and Morningstar.com.au. This article is general information.

Druckenmiller on the biggest mistake in the history of the Fed

Sohn Conference

At the 2023 Sohn Investment Conference in the US on 9 May 2023, Duquesne Family Office CEO Stanley Druckenmiller spoke about the US Federal Reserve's actions in the last two years and its impact on investing conditions. The entire interview went for over an hour, but we have selected these highlights.

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I (recently) read Edward Chancellor's *The Price of Time*. As you know, I've been saying for years that my observation was the worst economic outcomes tended to follow asset bubbles. I was only looking at the past 100 years or so. Chancellor's book is a real tour-de-force, and it describes how this has been going on for over 500 years. Basically, every time we've had interest rates below 2% going back 500 years, it's been followed with a difficult economic time.

I think it was actually just a little over two years ago, I went on national television and said we had monetary policy that was the most reckless and extreme relative of the economic circumstances I had ever seen. And at that time, inflation was 2.5%. You had a booming economy, we're coming out post-COVID and it was clear post-vaccines that we were on our way to maybe the most rapid recovery I have seen in my lifetime.

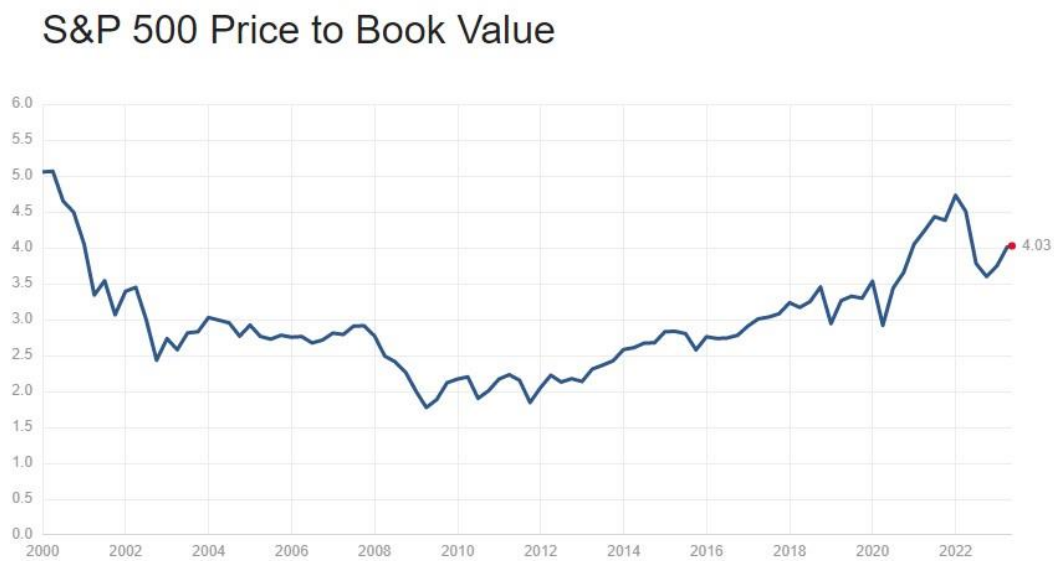
I was not surprised about a year later when inflation reached 9%. I was not surprised that SPACs went crazy, Bitcoin went crazy, Dogecoin went crazy, equities went crazy. What I was surprised by was that for the next year, while all that happened, Jerome Powell's Fed (Federal Reserve, the US central bank) continued to have their foot on the gas, they continued to buy US$120 billion of bonds a month while rates were zero. This obviously led to everything I just described.

Then realising they have probably made the biggest mistake in the history of the Fed, they slammed on the brakes. They raised rates 500 basis points (5%) in the last year. We know historically, two things happen.

Number one, the worst economic outcomes tend to follow too easily-engineered asset bubbles. And **number two**, big maxim in my business is Don't Fight the Fed.

So I'm sitting here staring in the face at the biggest asset and probably the broadest asset bubble - forget that I've ever seen that I've ever studied - and it went on for 10 or 11 years and then as the grand finale the government spent US$5 trillion on COVID and the Fed financed 60% of it.

(Editor note: As an example of a broad asset bubble, consider this chart, [sourced from Multpl](), of the S&P500 Price to Book Value ratio. It has only been higher in this period during the dotcom era of 2000 and the Fed-induced free money and loose monetary policy until 2022. Book value is the company's value in its financial accounts determined by subtracting its liabilities from the value of its assets. This exuberance comes at a time of rising interest rates, recession threats and tightening of bank lending).



As I just described, now we have a big hike in interest rates. It's hard to look at that constellation of factors, know that we've only had a few soft landings since 1950 and all of them were preceded by what I would call proactive rather than reactive Fed policy, and believe we're going to have a soft landing. One never knows. But if you're just looking at the odds, they're very tough. In terms of the timing, I have left much less certainty on that than I do on whether we're going to have a hard landing or a soft landing.

The timing is difficult, but I will say in our shop we tend to use anecdotal information a lot. It's somewhat mixed. Housing, which has tended to lead historically, is actually fairly robust. Travel and restaurants and stuff like that are fairly robust. But trucking, which has been a guiding light for my firm in terms of economic forecasting with a six-to-eight-month lead time, is extremely weak. We're hearing bad anecdotes from retail. The banking problem we always knew.

Given what I've already described, there were going to be bodies out there. When you have free money, people do stupid things. When you have free money for 11 years, people do really stupid things. So the stuff under the hood is starting to emerge. Obviously, the regional banks recently, we had Bed Bath & Beyond. But I would assume there's a lot more bodies coming. The median regional bank has 43% of their loans in commercial real estate, about 40% of that in office. We've had this huge change in lifestyle due to COVID. Number one, the great resignation and number two people aren't going to the office. So we have actually a higher vacancy rate than we had in 2008.

I put all that together and I look also at the inverted yield curve. The timing is sort of third, probably fourth quarter of this year, first quarter of 2024. I wouldn't be surprised if the bean counters a year from now - as they tend to do backward looking - that things started (to go bad) sometime in the second quarter.

Stanley Druckenmiller is Chief Executive Officer and Chairman of his Duquesne Family Office. He made his reputation as an astute asset manager from 1988 to 2000 when he was lead portfolio manager for George Soros's Quantum Fund. The full Sohn Conference interview is [linked here](). This extract is general information and does not consider the circumstances of any investor.

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