Edition 510, 26 May 2023

Contents

Editorial

One of the bigger furphies in the funds industry is that portfolio managers must invest all their personal wealth in their own fund to 'align their interests' with their clients. It is supposed to ensure they work longer hours, turn over more stones, travel the world looking for the best companies and avoid the '*spend more time with the family*' syndrome.

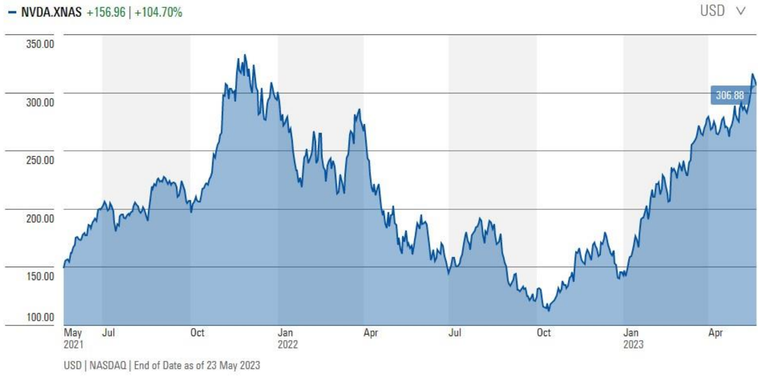
More accurate is that every fund manager is desperate for their fund to perform well, and putting 100% of their wealth in one strategy is poor asset allocation and likely to lead to more sleepless nights and worse personal relationships than are good for anyone's physical and mental health, and the fund's performance.

Next time this mantra is espoused by a fund manager, ask these questions:

"How is your performance improved by you holding nearly all your wealth in your fund? Will you work harder and better? Should I feel reassured when my $100,000 in your fund falls to $80,000 but your $5 million falls to $4 million? Why does it make sense for your wealth to be invested in your volatile small company fund?"

Funds management looks like (and often is) a glamorous job but every day is a competition against similarly-talented and driven people, both inside and outside their own firm. Imagine what happens when an analyst spends a month researching a company and deciding it is a strong buy, then after pitching the idea to colleagues, the proposal is rejected. It can feel like a takedown on a professional judgement. If a stock idea is rejected and then it rises strongly, everyone in the office knows and bonuses and pay increases may be hit.

For example, emotions are running high in some investment teams as **Nvidia**'s price rises and falls and rises with changing market sentiment towards AI. Despite its extraordinary rise in 2023, Nvidia is not back to the US$330 price reached in 2021. Pity the portfolio manager who bought in late 2021, giving up in October 2022 at US$112 as the stock collapsed, and it is now US$306. It's one thing to miss a trend like this. It's another to invest in it and exit just before it takes off again.



Source: Morningstar Premium

I have sat in the same office as fund managers whose arguments with colleagues are so aggressive and vitriolic that it's a wonder they can work together. I have seen stockbrokers black-banned for months by fund managers who feel an order was filled badly or a piece of information was withheld. It can be a tense environment where losing 1% in returns can mean underperforming a benchmark. For large super funds, it might mean a warning must be issued to all fund members and ultimately the threat of closure.

At the 2023 **Morningstar** Investor Conference yesterday, **Mark Delaney**, the Chief Investment Officer at **AustralianSuper**, made the surprising statement that only one in three active managers comes good after a period of poor performance, and he had often been too slow to terminate a mandate.

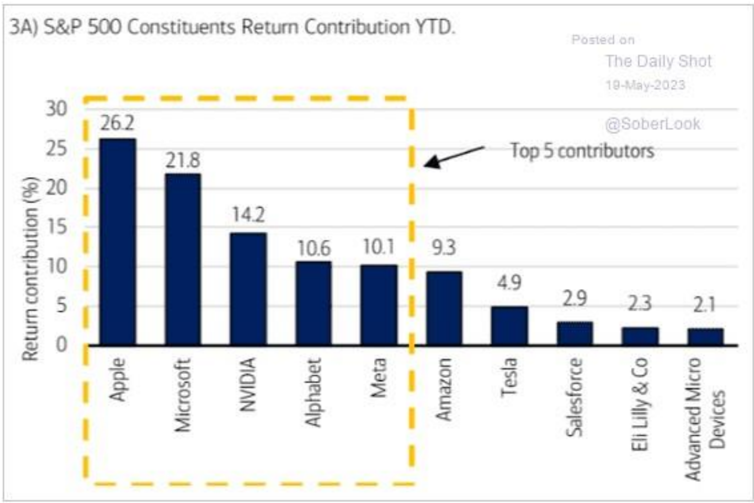
"When you look back, you should have got rid of them when you first start to worry about them."

And yet the index performance against which the manager is measured may be driven by market activity bordering on irrational, such as the BNPL or crypto or tech wreck frenzies. As **Morgan Housel** wrote on '[vicious traps]':

"Years ago someone told me that bubbles happen when confidence (a good trait), optimism (a good trait), trust (generally good) mix to form greed and delusion. The reason bubbles are so common is that the inputs are mostly innocent, even if the output is lunacy and destruction."

There is a remarkable event underway in the US which is driving up indexes (such as the S&P500 and NASDAQ) and causing massive winners and losers among global equity managers. When large companies make big moves, the funds which do not hold them are destined to deliver underperformance relative to their benchmark.

In calendar year 2023 to date, **Apple, Microsoft, Nvidia, Alphabet** and **Meta** account for over 80% of the S&P500's returns. This chart from **The Daily Shot** shows Apple and Microsoft alone have caused nearly half the rise in the S&P500, and any managed fund that does not own these two stocks will struggle to keep up.



Source: The Daily Shot

We even see the strange position where fund reports explain performance in terms of stocks *not* held. Here is an example from an April report of a leading Australian global manager:

"POSITIVE CONTRIBUTORS
Tesla (no holding)
Tesla shares declined over 20% in April after reporting lacklustre Q1 2023 earnings. Tesla pushed through aggressive price cuts to fend off competitors which impacted margins. Despite the company's manufacturing, brand, autonomous software, and US subsidies advantages, we believe the assumptions required to underwrite an acceptable return on Tesla shares are too high to justify holding a position in the Fund."

The fund did well in April because it did not hold Tesla. And many fund managers will soon report that they did poorly because they did not hold Nvidia and Microsoft.

Another side of the less-than-glamorous industry is when a fund simply cannot attract investors, and there are plenty that quietly shut down after starting with such optimism. We hear more about the successes but it's a grind if it doesn't work. For example, this week, **Blue Orbit**, a boutique small-cap fund manager formed in 2018 advised the market:

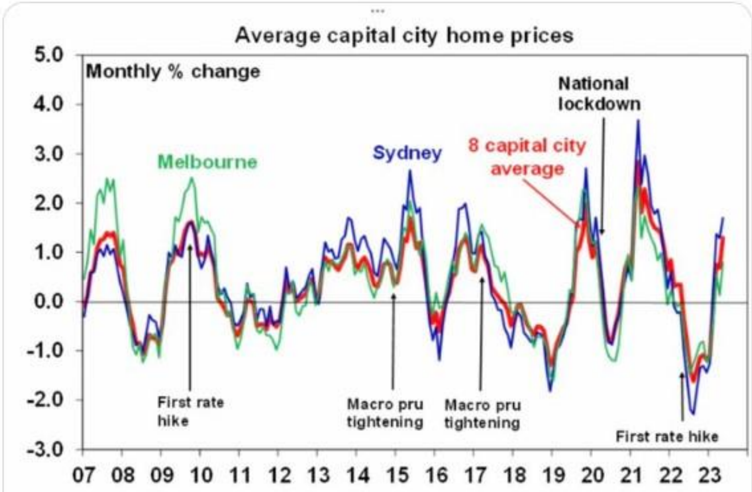
"After five years of hard work, real innovation, and a roller coaster ride of emotion, we are now selling/closing down Blue Orbit. The performance of our global small caps fund was very good - excellent versus most of our peers globally - but we were simply unable to raise enough funds. Both the global and Australian small caps funds are now closed."

It's tough. In the office by 7.00 each morning, read the newspapers, check every screen, meet with company management, slog through endless annual reports, debate furiously with colleagues, then do well but nobody wants you. Since inception, the fund was a decent 1.3% ahead of its index after fees when it last reported.

In funds management, it's difficult to know whether someone has a good track record because of skill, luck, membership of a talented team or because a particular style works for a while. While the data on active manager performance versus their benchmarks is not flattering, investors should be sympathetic if they miss out for while due to ignoring a bubble. Given time, they might be right.

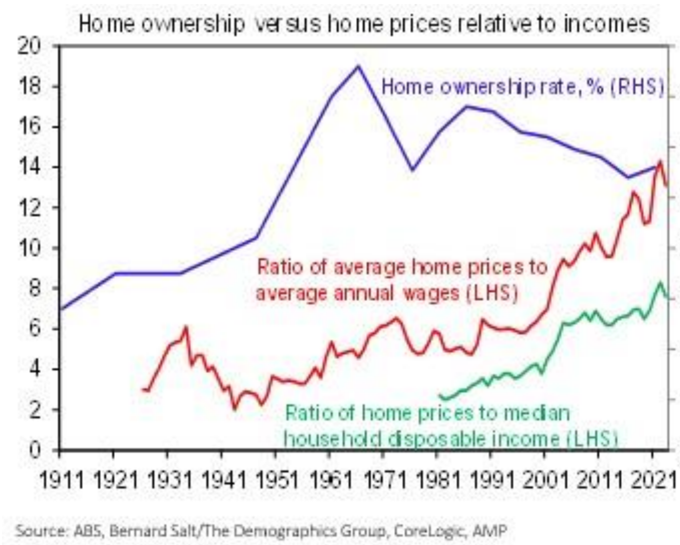
***

It is fascinating to watch residential property prices at the moment and speculate on the next year. As this chart from **AMP's Shane Oliver** shows, there is an unexpected price turnaround in the face of rising interest rates, due to high immigration, supply shortages and low availability of rental properties. Many people are helping their children to buy homes, and it may have implications for the cash rate. As Oliver says:



"Although the RBA does not target home prices, the rebound will be concerning them due to the reversal of the negative wealth effect, leading to a risk of more rate hikes."

Drawing on work by **Bernard Salt** of **The Demographics Group**, Oliver looks at many factors to explain declining home ownership, from a peak of 73% in 1966. He says many younger people are now investing in other ways such as on the stock market, and spending more on personal experiences. But a leading cause must also be a decline in housing affordability, as shown in the red and green lines below.



***

The Twitterati enjoyed a fun but serious subject this week with many examples of the 'shrinkflation' of smaller product sizes sold at the same price as larger predecessors. The Reserve Bank focuses on all aspects of inflation and the implications for interest rates, and shrinkage deserves more attention.

Even without the shrinkflation, the **UBS Evidence Lab** tracked more than 60,000 prices in **Coles and Woolworths** and estimates that supermarket prices rose 9.6% in the 12 months to April 2023.

Many people approach retirement with a relatively simple plan: own their home, retain some investments outside super and leave as much as possible in super for its favourable tax treatment. Government policies encouraged this independence in retirement. The new tax on super balances over $3 million brings other options into play, and we check eight investment pools with different tax treatments.

Although there was supposed to be a consultation period on the new tax, Treasury officials have said both the $3 million threshold and the inclusion of unrealised gains as earnings are non-negotiable. **Meg Heffron**'s monthly column also delves into the ways the new tax may make investing more complicated, with examples of anomalies Treasury is unlikely to have considered. As the start date of 30 June 2025 approaches, more complexity will surface.

Graham Hand

Also this week ...

Jack Gance is a rare entrepreneur who's created two dominant market leaders from scratch, including **Chemist Warehouse**. In the article by **Lawrence Lam** of **Lumenary Investment Management**, Gance reveals how he did it: from finding business niches, to innovative marketing deals to scale a brand, and expanding business advantages through exclusive supplier deals, and treating suppliers well. It's a front row seat to the thinking of a great businessman.

It may be hard to believe, but **Campbell Dawson** of **Elstree Investment Management** reckons the competitive advantages of Australian banks are underappreciated. He thinks they're among the world's best banks because of their deposit-taking dominance. It makes bank hybrids a rock-solid investment, in his view.

Hugh Selby-Smith of **Talaria Capital** warns readers not to be sucked in by the recent market rally. He thinks we're at the risky end of the equity market cycle and it's time to play defence. That means investors should prize income, excellent value, short duration, and rapid payback periods.

ASX small companies have had a hard time recently, underperforming large companies by a considerable margin. Liquidity in these smaller stocks has also slowed to a trickle. Yet **NovaPort Capital's Sinclair Currie** says conditions are ripe for a turnaround, and he reveals which stocks have good upside.

Andrew Macken from **Montaka Global Investments** says investors needs to evolve and develop their skills. He outlines five steps to improve an investment toolkit, including thinking probabilistically, running your own race and measuring yourself objectively.

In this week's White Paper, **ClearBridge Investments**, part of **Franklin Templeton**, has tested the short- and long-term return profiles of infrastructure against a backdrop of changing macroeconomic factors.

Curated by James Gruber and Leisa Bell

Eight investment pools in the new tax hierarchy

Graham Hand

There are only two reasons why people save for their retirement in the superannuation system. One, they are forced to by the compulsion of the Superannuation Guarantee, and two, to take advantage of the favourable tax treatment. The latest tightening of concessions is coming with the new 15% tax on balances over $3 million, and it adds another layer of decision-making for those affected. It is no longer straightforward that the more in super, the better.

Tax planning can become extremely complex and nuanced for individuals. This article looks at the major investment pool choices and taxes but does not attempt to address every individual circumstance.

Access to superannuation

The tax advantages of superannuation come at the cost of lack of access until one of the Conditions of Release is met. However, despite successive governments and reviews confirming super is intended to finance retirement, there are no limits to taking money out of super when the member:

- has reached their preservation age and retires
- ceases an employment arrangement on or after the age of 60
- is 65 years old, even if they haven't retired.

Therefore, when a government introduces a new super tax, most members in retirement can adjust their investment structures and if advantageous, take money out of super without paying an exit tax. The new 15% super tax brings other choices into focus.

The tax hierarchy of investment pools

The new tax may bring a level of complexity to investment pool allocation which is more trouble than it is worth. It's a personal decision but many people do not want to spend their retirement years, after decades of working hard, balancing investments between different pools to minimise tax.

On the other hand, retirees are affronted by the constantly-changing rules, when all they have done is used the superannuation system to save as they were encouraged to. They feel the rules of the game are tightening because they have played it well, and they will respond accordingly.

The simpler world of the past was to own a home by the time of retirement, leave some money outside super to spend, and hold as much in super for the tax advantages. For those who can be bothered, it’s not so simple anymore.

Let’s consider the investment pools according to tax treatment.

Pool 1. Investments outside super using tax-free thresholds

Personal income tax is calculated using tax-free thresholds with concessions for older people, such as the Senior Australians and Pensioner Tax Offset (SAPTO). For Australians generally, the tax-free threshold is $18,200, but for those subject to SAPTO, personal incomes above about $32,000 for individuals and couples combined above $58,000 are tax-free. Some people will avoid the complexity and costs of other structures by investing in their own names but check eligibility using a SAPTO calculator.

Pool 2. Superannuation in pension mode

A pension fund is tax-free for both income and capital gains, and the member pays no tax on a pension received. The Transfer Balance Cap (TBC) which places a limit on the amount that can move from accumulation to pension was initially set at $1.6 million, is currently $1.7 million and will move to $1.9 million on 1 July 2023. These limits are per person meaning a retired couple will soon have access to $3.8 million when opening new pension accounts (existing caps do not change).

In a few years with indexing and inflation staying stubbornly high, these limits will reach the $3 million level, as the TBC is indexed but the $3 million cap is not. Over time, hundreds of thousands of people will start balancing the opportunities of tax-free super against the $3 million tax.

It is sometimes claimed that Pool 2 is superior to Pool 1 because Section 116(2)(d) of the Bankruptcy Act provides that superannuation is excluded from property divisible amongst the creditors of a bankrupt person.

Pool 3. Investment in a Principal Place of Residence

Although many people argue a home is not an investment, the favourable tax treatment for social security eligibility and lack of capital gains tax means many Australians consider their home as a place to store wealth. The tax system encourages expensive homes and renovations as a way to both enjoy wealth tax-free and qualify for government benefits. There is no cap on this expenditure and a person can live in a $10 million home and receive a full age pension.

The above three pools allow investment without paying any tax.

Now we move into the pools which minimise but not eliminate tax.

Pool 4. Superannuation in accumulation mode

In accumulation mode, earnings are generally taxed at 15%, although there are further concessions for capital gains on assets held for longer than 12 months. Franked dividends can also offset tax liabilities.

Pool 5. Superannuation balances over $3 million

The new tax will commence on 1 July 2025 and apply from the 2025-26 financial year onwards for individuals with more than $3 million in super on 30 June 2026. Firstlinks has covered the choices and consequences extensively and we will not repeat all the alternatives in this summary.

It is incorrect, however, to describe this as a 30% tax regime, by adding the 15% tax in accumulation mode and the new 15% tax on balances over $3 million. The definitions of 'earnings' in each are radically different, with the most notable being the taxation of unrealised capital gains in the high balance calculation.

An asset that rises in value by say $1 million in a financial year will face the new $3 million tax calculation, but if unrealised, it is not in the first 15% tax on accumulation funds. It may also not be taxed at 15% because it is the proportion over $3 million that is taxed. Plus it is possible to hold $3 million in a pension account which is taxed at zero, then pay 15% on the rest, without paying 30% in total.

The additional 15% tax brings into play comparisons with other tax structures which pay tax at 30% but are not subject to the tax on unrealised capital gains.

This is where the new tax changes the game for those planning their tax affairs according to the tax consequences.

Pool 6. Family trusts

A trust is a structure that holds assets on behalf of beneficiaries. Family trusts are used to distribute income, and therefore tax obligations, amongst multiple family members, especially to lower-income earners.

For example, a family trust might include two high-income parents on the highest marginal tax rate and two children who are adult full-time students with no other income. The investment income could be redistributed to the students, subject to special rules on taxing income of minors under 18-years-old.

A trust must distribute income in the same year the income is earned but it cannot distribute losses which can be used to offset capital gains either in the same year or carried forward. Trusts are eligible for the 50% capital gains tax discount after holding an asset for over 12 months.

Anyone setting up a trust should seek professional advice and expect ongoing costs, and there are other factors to check. For example, some Australian states charge higher land taxes on trusts.

Pool 7. Private investment companies

Investors can place money into a personally-controlled company which is a separate legal entity. Unlike a trust, there is no requirement for a company to distribute income each year, allowing the company to accumulate assets like other savings pools such as superannuation.

The tax rate is 25% or 30% depending on circumstances, which may be less than marginal tax rates. When dividends are paid by the company, the franking credits held by the company pass to the recipient.

A company is not eligible for the capital gains tax discount afforded to individuals and trusts. Companies have initial set up costs, ongoing advice and administration costs.

Investors may utilise a structure where one of the beneficiaries of a trust is a 'bucket' company. The company receives income from the trust which is then invested by the company and taxed at company tax rates rather than higher marginal personal tax rates. Assets can be held in the company and income distributed later. One advantage of this structure is the earnings in the company are not subject to tax on unrealised capital gains, as the new $3 million super tax imposes.

Financial advisers and accountants are already promoting this structure to clients.

Pool 8. Others such as investment bonds, family loans and philanthropy

All investment portfolios are unique based on individual preferences and circumstances, and an infinite array of ways to accumulate wealth or spend money. Many alternatives can fit into this final pool but three are increasingly popular.

One, investment (or insurance) bonds will become more competitive due to higher tax rates on super and are worth considering by anyone who has a marginal tax rate greater than 30%. As long ago as 2015, Firstlinks published an article called, "Will insurance bonds become the new superannuation?".

Two, with the rise in residential property prices and interest rates, adult children increasingly rely on the Bank of Mum and Dad (and maybe the Bank of Grandfather and Grandmother) to buy a home. Instead of leaving money to children in an estate, parents gift or loan money earlier. It has also become common for bequests to skip a generation and go straight from grandparent to grandchild.

Three, with wealth accumulated, more people turn to philanthropy, including giving to charities or opening Public or Private Ancillary Funds, which not only help those less fortunate, but give the donor a tax deduction.

Interplay between pools

Faced with many choices, investors do not need to set and forget. They can rebalance between the pools regularly as values rise and fall and tax implications change.

For example, while the limits on the amounts that can be invested in superannuation continue to tighten, there are no limits to the amounts invested in companies, trusts or insurance bonds.

When personal taxable income is less than the tax-free threshold, the company can pay dividends into the pool allocated for personal income, until the pool is full. Where more income is needed, a company can pay back some of the money invested.

Money must be drawn out of a superannuation pension fund each year according to mandated minimums.

And critically, at some stage, a major decision is required when to transfer money out of super to avoid the 17% 'death tax' when super is inherited by a non-dependant who is not a spouse.

How does this relate to the common 'bucket' strategies?

The use of these pools based on expected tax treatment should not be confused with the common financial planning technique of using 'buckets' to manage income needs.

This strategy involves dividing a portfolio into different buckets according to expected cash flow needs. There is a cash bucket of highly-liquid assets for living expenses, maybe based on cash needs for a few years to avoid selling down a share portfolio if the market falls. A second bucket might include bonds or term deposits that provide income but mature in three or four years. Riskier assets such as shares are placed in a third bucket for longer-term growth.

This bucket strategy can operate alongside the pools. For example, a retiree could include cash in each of a superannuation, personal or company pool and draw out as needed. However, a product like an investment bond would need to fit into a longer-term bucket.

Graham Hand is Editor-At-Large for Firstlinks. This article is general information and does not consider the circumstances of any person, and personal financial and tax advice should be obtained by anyone considering the complexities of using different pools for their investments.

Chemist Warehouse founder reveals his success secrets

Lawrence Lam

Jack Gance is a rare entrepreneur who's created not one but two dominant market leaders from scratch. He built Australia's leading pharmacy retailer, Chemist Warehouse, after founding and ultimately selling Le Specs, one of the top brands in fragrances, cosmetics, suntan lotion and sunglasses. Throughout my interview with Jack, he sprinkles lessons in getting businesses off the ground with limited capital, on how to create and extend strategic advantages, building businesses for the long-time, as well as the importance of making fair deals with suppliers.

Getting your foot in the door

Within the opening few minutes of our interview, it becomes apparent Jack chooses to take calculated risks in areas where he has a strategic advantage.

'*What exactly do you define as a strategic advantage?*' I ask. In a matter-of-fact tone, Jack explains it's about getting yourself into unfair fights.

For example, the Le Specs sunglasses business was launched as a pharmacist-to-pharmacist wholesaler. Jack and his brother Sam were themselves qualified pharmacists with their own established pharmacies. Jack had the insider's advantage of being a relatable colleague familiar with how pharmacists should position the product. Jack was able to distinguish Le Specs, which had a unique feature of being unbreakable, from the hundreds of other sunglass products and distributors to garner the support of fellow colleagues.

The insider's angle combined with a unique product proved to be enough of a differentiator to give Jack the leg-up he needed. He knew how to price the sunglasses, and he could coach his sales team on how to maximise sales.

He recalls a time when he would ask pharmacists to step on the sunglasses to demonstrate why they would appeal to the masses. He would also encourage them to repeat this in front of customers as a way to grab their attention.

Combined with the attractive wholesale prices, Le Specs was an immediate success. And as any founder would, Jack pressed on further with an innovative marketing deal which would propel the brand on a national level.

The first break with limited capital

Jack recalls approaching an advertising agency in 1979 to propose a unique marketing deal. At the time he didn't have the capital to invest large amounts into advertising. Instead of Le Specs giving the agency a large upfront fee, the agency would receive a percentage of sales. In return they would help brand, launch and create the advertising for the product. Jack won them over by '*throwing the sunglasses on the ground and stepping on them*'.

The deal incentivised the advertising agency and it went above and beyond to promote the product, finding extra TV marketing slots for Le Specs that otherwise would not have been filled. A year later, Le Specs expanded nationally, having established itself as the market leader in tough and affordable sunglasses.

The marketing deal allowed Jack to limit his initial capital outlay, de-risk the venture and create an incentive structure with the advertising agency that would allow Le Specs to gain national brand recognition.

By the time competitors entered a year later, Le Specs had already established a substantial lead in market share and support from customers. As Jack says, *'the advertising deal gave us the break we needed to kickstart our operations'.*

Minimise initial risk and capital outlay, gain a foothold and expand your strategic advantage over time is the modus operandi that would resonate through Jack's career.

Expanding your strategic advantage

As more competitors entered the market, Jack had to secure exclusive distribution agreements from the French manufacturer. On one trip, he flew to Lyon to meet the manufacturer to convince it that he should be the sole distributor in Australia of its unbreakable sunglasses. Exclusivity helped to temporarily prolong Le Specs' first mover advantage, crucial in the early stages of the business.

Over time, more manufacturers appeared but Jack could only secure exclusivity deals with so many. He could see Le Spec's strategic advantage was under the microscope of its competitors, soon to be studied, dissected, and replicated. But Jack had other ideas to broaden his business. In his mind the key question was: *Is Le Specs a sunglasses business, or is it a distribution business?*

With the leading brand name and national sales channels, Jack saw Le Specs as a distribution business first, which just so happened to sell sunglasses. And with this conclusion, the way he needed to expand his strategic foothold was to sell another product to his customers.

It was Jack's intention to diversify into a winter-orientated product to balance out the summer-heavy sales of sunglasses, but he struggled to think of any promising ideas. Instead of taking a dogmatic approach, Jack went with developing another summer product - suntan lotion. Yes, it meant his sales profile was heavily tied to the summer season, but suntan lotion had the advantage of being an easier sell. Jack's orchestrated sales process made sure every salesperson pitched a bottle of suntan lotion at the same time they sold a pair of sunglasses.

The lotion was branded Le Tan, designed to ride off the positive branding of Le Specs. It worked. Sales grew organically as the product range expanded.

With the self-clarity of knowing he was running a distribution business, not a sunglasses or suntan lotion business, there was an impetus to keep rolling out new products. The next idea was the perfume market, which was a much larger market and traditionally sold through department stores, not pharmacies.

This led to the acquisition of Australis, a brand which had struggled to grow. The reason, in Jack's view, was because Australis's branding was competing head on with fragrance brands like Chanel and Dior. The branding was too serious and would always lose in a battle for sophistication. Instead, Jack emphasised the need for products to create a 'smile factor'. He countered the strategic advantage (and million-dollar marketing budgets) of the well-established European brands, with a fun factor with which they could not compete. He commissioned artwork from Ken Done and progressively launched variants of Australis products each year. Australis was followed by Australis for Men, which was followed by Love Is Australis. Sales volumes were stable each year, but the growth came from expansion of new product lines.

Jack gestures the size of each market to me. *'The sunglasses business is this big, the suntan lotion business is this big, the perfume market is this big,'* his hands widen as he describes each market. And finally, he describes his eventual move into cosmetics and widens his hands even further. *'And that's why I decided to move into the cosmetics market with Colors of Australis*, which is *this* big.'

With each product launch, Le Specs' offering widened. Concurrently to the growth of the distribution business, Jack and his brother Sam would simultaneously expand their footprint of pharmacies which went from two stores to 35 while the distribution business was expanding in its own right. This chain of stores would eventually be branded as the MyChemist chain of pharmacies.

The hidden benefit of running both a distribution business and a chain of pharmacies was the inside knowledge of which products sold best. The pharmacies owned by Jack were used as testing arenas for different colours of eye shadow, lipstick and makeup - once demand was established, the new line would be sold externally to other pharmacies.

Fine tuning the optimal business model

There are businesses that face structural headwinds more than others. For example, some businesses generate revenue on a per hour basis, which naturally limits how truly scalable the model can be. That is not to say these businesses cannot be profitable and successful, but they face greater challenges and are more vulnerable to adverse market conditions. This was the nature of Jack's distribution business.

As revenues grew, the working capital required to manufacture and pre-order the sunglasses, suntan lotion, cosmetics and fragrances snowballed. This business model required a large outlay of cash each year, with cash sales received sometimes up to one year later. There would be a build-up of debtors over the year. Compounding this headwind were the banks, which offered working capital financing but required a personal guarantee from Jack and Sam. The larger the business grew, so too did the working capital outlays. It made Jack uncomfortable knowing that he was personally vulnerable to any unforeseen changes in market conditions.

In 1990, 12 years after he started the Le Specs brand, Jack received an offer to sell his business. He and Sam didn't hesitate to accept, knowing the buyer had much deeper pockets to absorb the working capital requirements.

The experience gained from the distribution business would serve Jack well in years to come. Jack and Sam had a group of 35 pharmacies in various partnerships and re-focused on growing those to 50 stores. It would be the early formation of what would become Chemist Warehouse - the second phase of Jack's career and his biggest success.

Part 2 of this feature story on Jack Vance will appear in Firstlinks next week.

Lawrence Lam is Managing Director & Founder of Lumenary Investment Management, a firm that specialises in investing in founder-led companies globally. We search for unique, overlooked companies in markets and industries with a long runway for growth. We are a different type of global fund - for more articles and information about us, visit https://lumenaryinvest.com

The material in this article is general information only and does not consider any individual's investment objectives. All stocks mentioned have been used for illustrative purposes only and do not represent any buy or sell recommendations.

Meg on SMSFs: Adjusting to the new tax on super over $3 million

Meg Heffron

In a monthly column to assist trustees, specialist Meg Heffron explores major issues on managing your SMSF.

At the 2023 Federal Budget, the Government recommitted to introducing a new tax on super fund earnings for those with balances above $3 million. While there was a short public consultation period from 31 March to 17 April 2023, I expect the tax will be introduced pretty much as already outlined by Treasury. It will probably include all the contentious aspects, my top three being:

- Applying the tax to unrealised capital gains
- Not giving a tax refund for those whose super assets subsequently fall in value, and
- Not indexing the $3 million threshold.

I suspect any changes will be relatively minor.

Choices for those with a lot in super

Anyone who has retired or made it to 65 has numerous choices where they save, and those impacted by the new tax need to decide whether they take a lot of their wealth out of super.

They could choose to invest in their own names, as a discretionary trust, as a company, or some combination. The right mix will depend on lots of factors, including their existing non-super structures, their plans for the money, estate planning, the amounts involved, etc.

To start, consider the choice of:

- Taking money out of super and putting it in a family trust
- That trust making distributions to individuals where it makes sense from a tax perspective (such as where they have little other income) but paid to a company where it is desirable to cap the tax rate at 30%, and
- A few other nuances to recognise that different types of income are taxed in different ways.

For example, it's often better for family trusts to pay capital gains (when they sell assets) to a person even if that person pays tax at the top marginal rate of 45% plus Medicare, rather than a company which pays tax at only 30%. This is because individuals don't have to pay tax on all of the capital gain.

The Stage 3 tax cuts are also relevant as it looks like these will go ahead as planned. If so, individuals and companies will pay virtually the same tax rates up to incomes of $200,000 (the difference is Medicare) so it might not be worthwhile introducing the complexity of a company in the trust structure. In the following, I've assumed these tax cuts **will** happen.

Think differently after 30 June 2025

In that case, should someone with a Total Super Balance (TSB) well over $3 million extract wealth from their SMSF?

It's not possible to make one statement for all people, so let's go with … maybe, but maybe not.

For many – particularly funds with assets held for a long time showing substantial unrealised gains already – leaving the money in super might still be best. One of the drivers here is the way the earnings calculation works for the new tax. Remember that the new policy will commence on 1 July 2025 and apply from the 2025-26 financial year onwards for individuals with more than $3 million in super on 30 June 2026.

Consider a single member fund that has a number of different assets but let's focus on one, a property valued at $4 million at 30 June 2025. The gain in value since it was first purchased is $1 million. When it is sold in August 2027, it is still worth around $4 million. In other words, its value grew a lot initially but then plateaued. When the property is sold, the fund will have a $1 million capital gain in 2027/28 but none of this will impact the earnings calculation for the new tax.

The earnings calculations for 2025/26, 2026/27 and 2027/28 are only concerned with growth in those years specifically, not what has happened in the past.

However, the tax implications would be different if all the growth had occurred after 30 June 2025.

So one important takeaway here is that after 30 June 2025, think differently about assets your SMSF already owns versus purchases in the future, and plan for those changes now.

What about new investments after 30 June 2025?

If this same fund was now considering purchasing a **new** asset with its $4 million, would the new tax impact the decision? Would it now be more attractive to buy that new asset outside superannuation?

Let's start with a simple example. If the new $4 million asset simply generates income each year and no growth, even **with** the new tax, super is probably still better. This is because the new tax is not exactly the same as just applying a 30% tax rate (15% in super plus 15% of the new tax) to this income amount. In fact, the new tax is applied to a lower amount as the fund will have paid the initial 15% tax on those earnings already.

But one of the things everyone hates about the new tax is that it includes tax on unrealised gains. That means each year, there is more tax paid as the assets grow if they are held in super. So surely this simple analysis has to change if the asset is **also** growing in value?

Let's use some numbers to explore it further.

Consider an individual with a $7 million super balance ($2 million pension account, $5 million accumulation account). The fund has just sold its $4 million asset and so has cash. This person is weighing up whether they should take this $4 million out of super and invest elsewhere. Let's assume each investment (whether held in superannuation or outside superannuation) produces income (rent, dividends, interest etc) of 5% pa and capital growth of 3% pa.

After 1 year, the total tax paid from all sources (in the super fund, the new extra tax) would be around $82,000 if all wealth remained in superannuation.

In contrast, the total tax could be as low as $65,000 (approximately) if $4 million was moved outside super and invested via a family trust.

In other words, investing **outside** superannuation looks far more attractive as it saves $17,000 pa in tax. But the tax equation changes the moment the asset is sold.

For example, if it was sold at the end of the first year, this tax saving evaporates entirely. The 'remove it from super' option would actually be worse by around $10,000 than leaving everything in super.

Even if we project this out over several years and assume the asset is not sold for another five years, the "remove it from super" option still looks worse because of the benefits of realising capital gains inside super rather than other structures.

This feels counterintuitive. Even if we take a superficial approach and add the two 15% tax rates, it 'feels like' the comparison should be roughly:

- At worst, the super fund will pay an effective rate of tax on capital gains of 10% (15% but applied to a discounted amount) and the new tax more or less taxes gains at 15% as they accrue. These two add up to 25%.
- This is about the same as a discounted gain distributed to an individual taxpayer who – at the very worst – would pay tax at 45% plus Medicare on half the gain (effectively 23.5%).

Given that the first option involves paying tax on some of that gain progressively while the second allows it all to be deferred, it feels like the 'remove it from super' option should be better.

But the positive outcome for leaving the money in super reflects the interaction of a number of slightly complex variables and the end result is pretty close, with super winning.

What about death taxes?

The big risk with super is death.

When a super member dies and their money goes to a spouse (either directly or via the estate), it's not a problem. But if it goes to financially independent adult children, they potentially pay **a lot** of tax. Not on **earnings**, but on **capital**.

This isn't a new issue or one that's created by the new tax. But it is a big weakness with leaving money in super for too long.

So perhaps that's actually the message here. The new 15% tax on earnings won't necessarily push a lot of money out of super but it will focus attention on the death tax. It's a reminder that if super is likely to be inherited by someone who is subject to the death tax, it should come out before we die.

Meg Heffron is the Managing Director of [Heffron SMSF Solutions](), a sponsor of Firstlinks. This is general information only and it does not constitute any recommendation or advice. It does not consider any personal circumstances and is based on an understanding of relevant rules and legislation at the time of writing.

For more articles and papers from Heffron, [please click here]().

Why Aussie bank hybrids are rock solid

Campbell Dawson

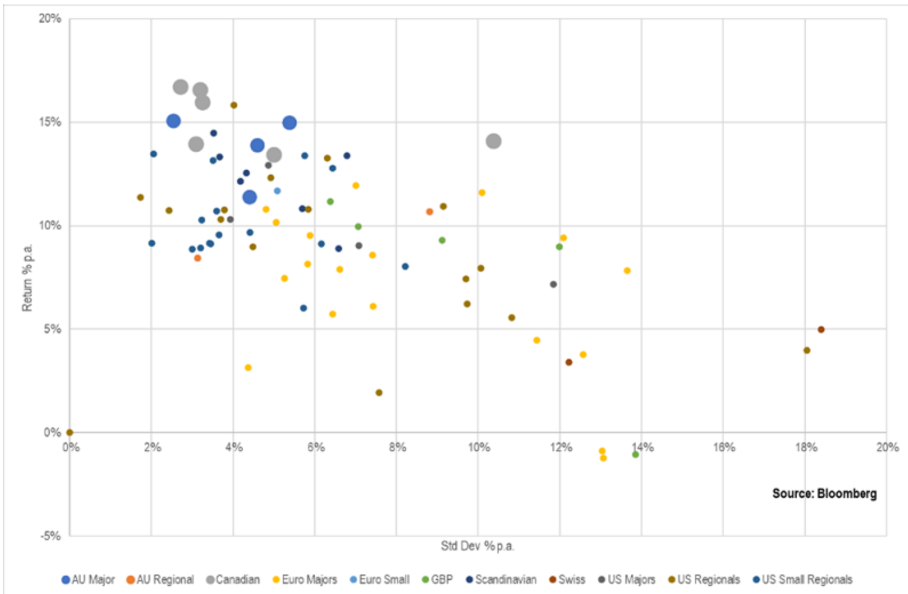
In 2008, a combination of Rio Tinto management mistakes and the GFC saw the RIO share price fall from a May 2008 high of $124 to $41. The Chinese sensed an opportunity and lobbed a cheeky bid for some of the assets and a 18% stake at a premium to the market's valuation. Apparently, the Chairman of RIO finally said:

"There's only one Pilbara, it only gets sold once and it never gets sold cheap."

The Pilbara and RIO's mines were easily the lowest cost in the world, closest to the end-user market and an honest government. They were the premier resource assets in the world and irreplaceable. The RIO price has increased fourfold since then.

In the same way, the major Australian banks (along with the big 5-6 Canadian banks) are the Pilbaras of the global financial system. Rock solid. The banks have high returns, low volatility and enormous moats which have been, and will remain, structurally impenetrable.

This first chart shows average Returns on Equity (RoE) since 2000 (vertical axis) and the volatility of those returns (horizontal axis) for 90 banks on both sides of the Atlantic (and Australia). We've split them by domicile and highlighted the Australian (large blue dots) and Canadian banks (large grey dots). It's apparent which banking groups to invest in.



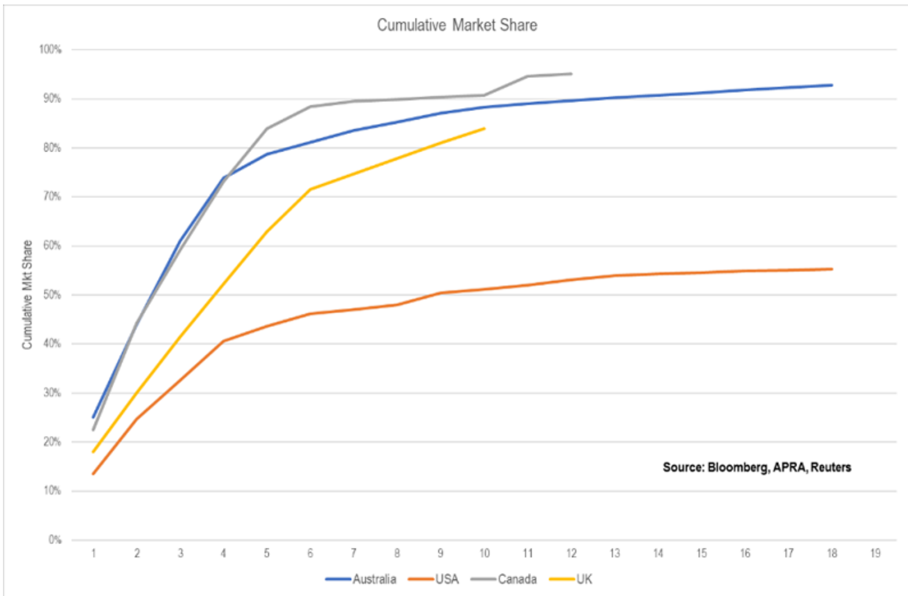
Banking 101 and bank strength

Successful banks do three things: be in a position to borrow enough money, at the right price, and lend to customers at the right price. Muck one of the three up and you don't make enough profit. The big four

Australian banks can make supernormal profits because they control deposits in a manner which is largely unparalleled.

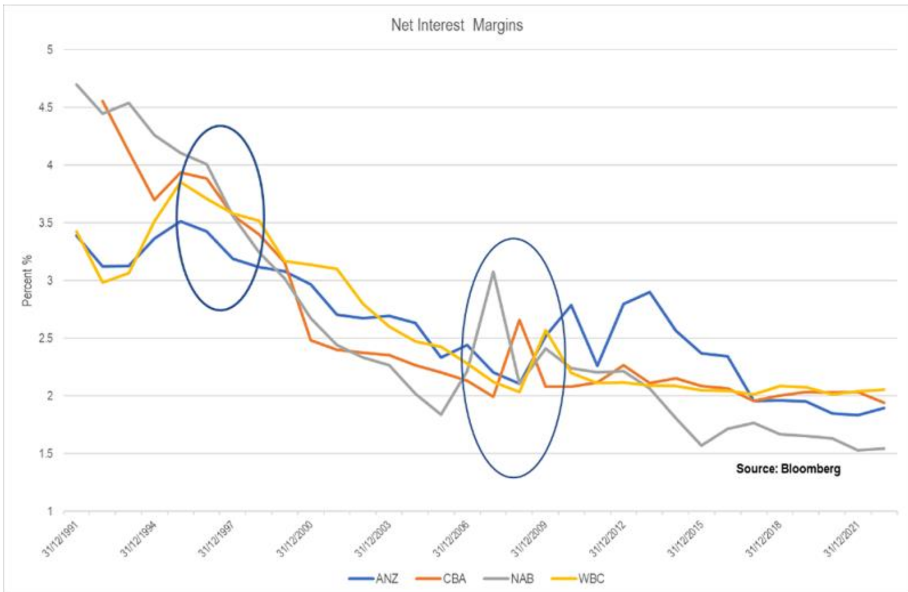
In 2002, the big four gathered 66% of all deposits with the fifth-largest (St George) having an 8% market share. In 2023. it's 78% with Macquarie the next largest at 5%. Is that 20 years of progress? More like 20 years of banks using the occasional crisis to strengthen monopoly positions and a lazy or ineffective competition regulator.

The next chart shows the deposit dominance of Australian and Canadian banks compared with the US and UK banks (note UK data is market share of mortgage lending, not deposits, so not exactly the same thing). The cumulative market share (vertical axis) is shown by the number of banks (horizontal axis). So, In Australia and Canada, we pretty much all dump our money in the top four banks. No other bank can get a foothold.



Deposit control leads to margin pricing power

The link between controlling the deposit market and monopoly profits is net interest income and the key short-term driver of that is the Net Interest Margin (NIM). The chart shows NIMs of the major banks since the early 1990s. NIMs have been in a structural decline since the 1970s, but there are two significant periods when NIMs were increased, which are circled. The first was in the early 1990s when all but NAB and to a lesser extent CBA (both lost less money on commercial property in that period than the other two banks) put their margins up. Post GFC losses, they all increased margins.

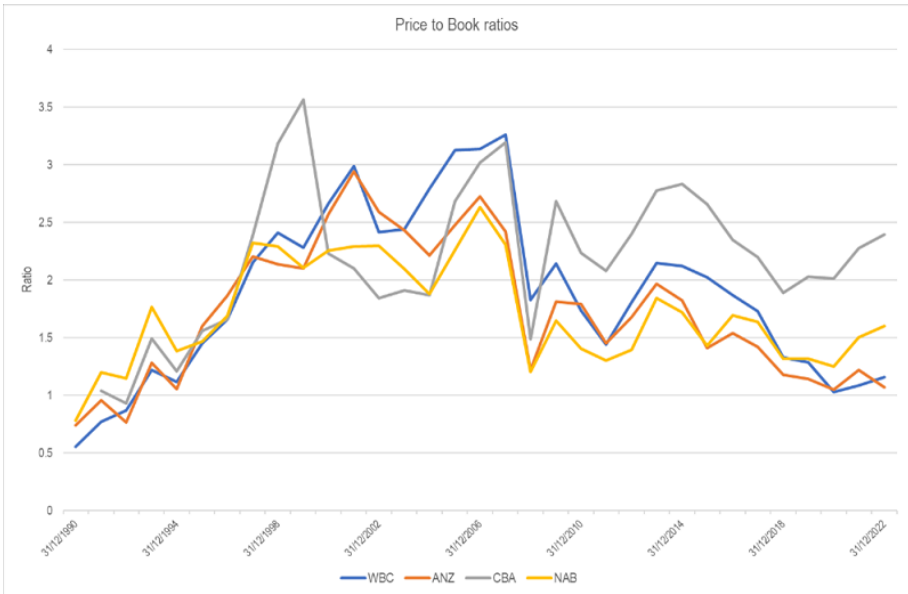


So, banks will gently compete against each other, and margins slowly fall. If there are general, or bank specific, speedbumps, banks put their margins up for a few years to play profit catch up. It's not long enough for smaller banks to gain market share, so we're then back to the status quo of the 'four-opoly' earning supernormal profits. Once profit is restored, banks resume normal business of lots of smoke and not much bang about competition to see if they can gain a few more percent of market share without hurting profits too much.

What does this mean for hybrids?

The big risk for hybrids is that APRA declares non-viability and hybrids get converted to equity. For the past decade since 'non-viability' was introduced, we've never seen anything but super-viability.

If the probability of non-viability increases from the current near-zero to a higher number, we would expect hybrid prices to decrease. Both are not good outcomes. However, we think the excess profitability makes non-viability risk extremely remote. Price-to-Book (P/B) is a good metric for what the market thinks of the prospects of banks. If it is well below one, markets are assuming ongoing low profitability, hidden bad losses, problems with deposit funding or big upcoming equity issues. All these factors would indicate warnings about non-viability. The chart shows the P/B ratios for the big four since the 1990s and it's a pretty picture for hybrid owners.



In the early 1990s which was probably the worst general banking crisis since the 1930s (maybe the 1970s?), system average P/B fell to 0.8 for a year (with WBC at around 0.6). Since then, system P/B fell to 1.2 during the GFC and Covid. No major bank has had a P/B below one since the 1990s.

As a contrast, the P/B of Credit Suisse was below 0.5 for the last three years and many of the big European banks have been below 0.6 for most of the last decade. The previous last big Euro bank resolution was the Banco Popular Espanol, which had a P/B of less than 0.1 for 2-3 years. That's what non-viability looks like.

Can the big four become non-viable? Not from assets

We can't see how the big banks can become non-viable from developments on the asset side. There is a massive virtuous circle of guaranteed profitability which means they can raise equity capital at a reasonable price, in addition to the natural accrual via profits.

In contrast, Euro banks haven't been able issue capital because their P/B ratios are so low that equity raising is prohibitively dilutionary. They have had to zombie themselves to life by slowly reducing the balance sheet and retaining what profits they made, thus raising equity levels.

Deposit non-viability

As we have seen with Silicon Valley Bank and Credit Suisse, a deposit run kills banks quickly. This is where a disaster becomes intriguing. What if Australian depositors started a run on one bank? Where do they put their money? In one of the other big four? Given they all do pretty much the same thing they should all be suffering the same stresses, so that's not a solution.

We think that a severe enough systemic problem would see the government guaranteeing all deposits. Is that a non-viability event and what does APRA do? Do they convert hybrids and Tier 2 and write equity off and let the government own the entire banking system? That doesn't look like a good idea, but anything less than that should leave equity relatively unaffected and hybrids untouched.

Are remote risks already priced in?

Clearly there are fat tail risks for hybrids in times of severe banking stress, but we think they are priced in. Trading margins of 2.5% - 3% imply a situation where hybrids suffer 50% loss every 25 years. We think that is grossly pessimistic given the industry structure. In a practical sense, hybrid prices will fall well before we start getting into the theoretical universe of non-viability.

Campbell Dawson is Managing Director of [Elstree Investment Management](), a boutique fixed income fund manager. This article is general information and does not consider the circumstances of any individual investor. Financial advice should be sought before acting on any opinion in this article. Elstree's listed hybrid fund trades under ticker EHF1.

'Prepare for war' with hostile markets

Hugh Selby-Smith

An ancient Latin adage advises '*if you want peace, prepare for war*'. This is useful advice for current market conditions. This may seem a surprising comment considering the recent performance of global equities. After all, indexes are up, and volatility is down. Never mind that a handful of tech giants like Apple and Microsoft are driving the headline positive numbers while most shares are having a harder time.

And there has been good news. It has gone quiet in the global banking sector after the debacles in US regional banks and the demise of Credit Suisse. This offers comfort to anyone who has been in markets long enough to know that stress in the financial sector is often the first sign of real trouble.

But even if they are not ringing as loudly as they were, we still hear alarm bells warning of potential difficulties on a broader front. While the banking sector has so far avoided systemic problems, at the very least these events should inhibit economic activity.

Already cautious loan officers have further tightened their standards. Consumers are also likely to adjust their behaviour increasing saving and cutting spending. Corporates too will inevitably look more closely at their liquidity and raise the required return of any potential investments.

Regardless of recent performance, our view is that we are in the 'risk averse' stage of the current equity market cycle. Therefore, the balance of probabilities is heavily weighted towards falling indices and negative returns, and we believe this will continue to play out through to mid-2024.

There are several data points that we believe support our concerns, including:

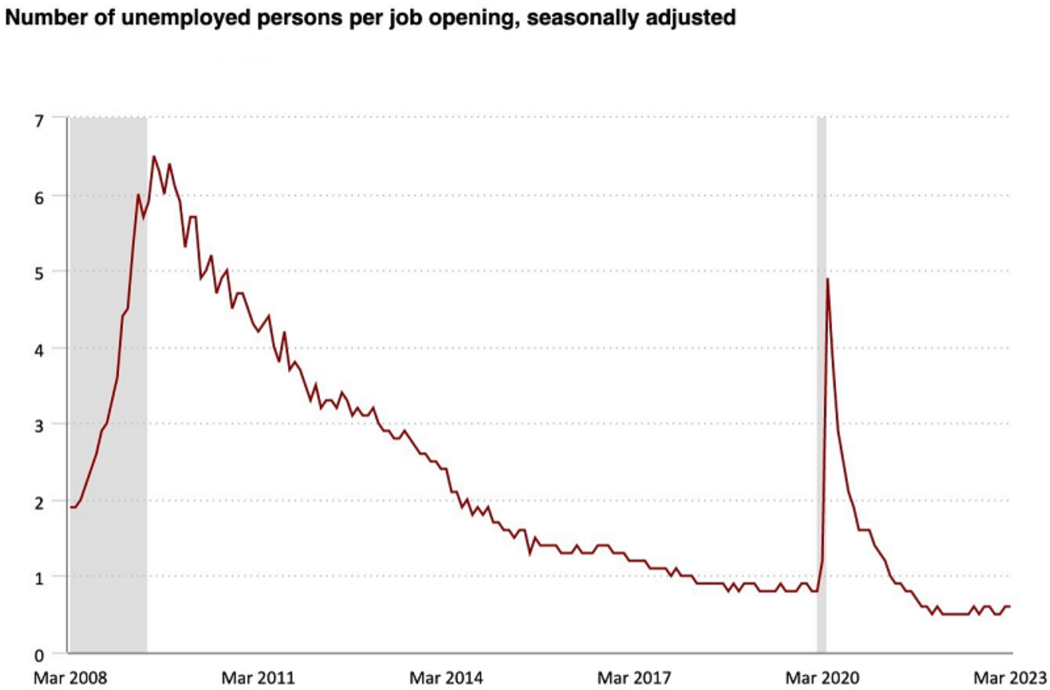
1. Government deficit and corporate profitability

Around the world, the COVID-19 pandemic triggered increases in government deficits. While the resultant growth in the stock of debt remains huge, deficit spending itself will provide no further sugar rush to business profits. For example, in the US, the deficit is currently set to remain at between 5-6% of US gross domestic product (GDP) rather than ballooning as it did during the pandemic.

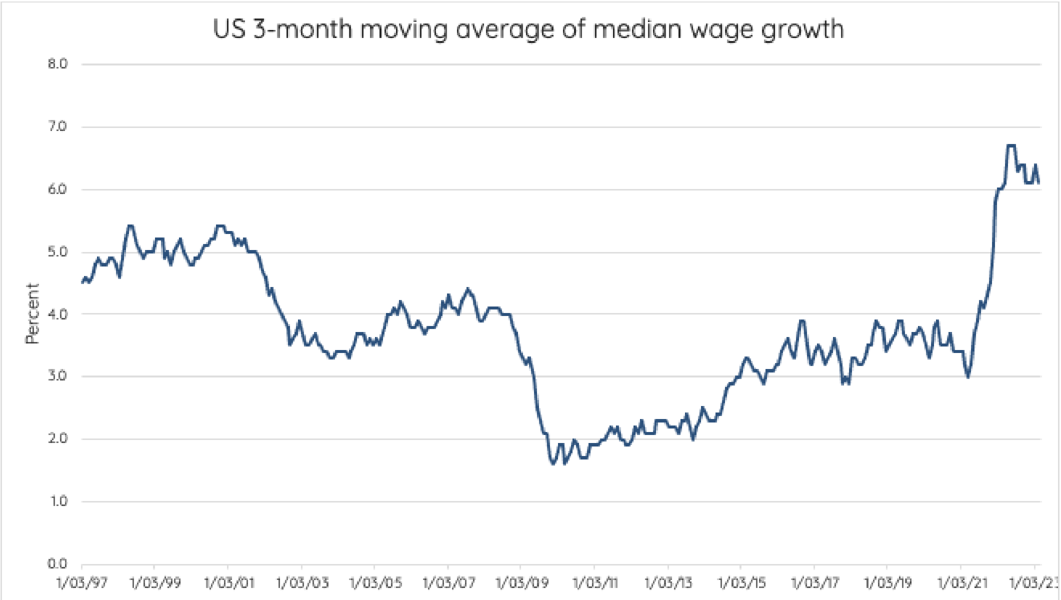
Furthermore, business profits should no longer benefit from consumers spending their way out of lockdowns. In the US the savings rate has fallen to 4.7%, from the extraordinary 33.8% during the beginning of the pandemic. If anything, savings rates may well rise from here.

2. Labour costs

According to the US Bureau of Labor's statistics, there are currently twice as many job openings as there are people to fill them. This is as high as it has been at any time since the GFC (Global Financial Crisis). The consequences of worker shortages are showing up in median wage growth which has accelerated since the start of 2021.



Source: US Bureau of Labour Statistics



Source: Federal Reserve Bank of Atlanta

3. Interest rates

Up until 2022, the falling cost of corporate debt helped boost businesses' margins. But since central banks started increasing rates, interest costs have grown and compressed margins. Meanwhile, it is difficult to envisage a situation where interest rates will meaningfully fall.

4. Taxation rates

In the US, the government is considering raising the marginal tax rate on US-derived profits which will turn what has been a tailwind in recent years into a headwind.

5. Earnings per share (EPS)

According to Bloomberg, current year S&P 500 EPS estimates peaked in June last year at $248 with the latest at $220. Looking at leading indicators, EPS could easily fall to below $200, perhaps materially below. If that seems unlikely, do not forget that the 2019 pre-pandemic high was just $164. Reversion to that level would put an S&P 500 index at 4000 on an eyewatering PE (Price Earnings) of 24 times.

Considering this, three areas for investors to look at to help manage risk are:

- Valuation – while the debate around value versus growth is perennial, what is inarguable is that buying a dollar for 80 cents means there is 25% upside available to a value investor that a growth investor often misses. This is not to say that value investing is like shelling peas, but that it does offer an added source of potential return.
- Income – remember the importance of income. In terms of the two components of total return, the bull market that ran throughout the last decade trained global equity investors to focus on capital growth more than income. But income always plays a positive part, while the same cannot be said of capital growth.
- Discipline – take steps to avoid behavioural biases that are repeatedly the cause of investment errors. Examples are recency bias (favouring what has just happened) or confirmation bias (sifting for data that support an already formed view). Swerving such pitfalls is difficult, but a disciplined process that is aware of the dangers helps.

We live in a probabilistic world, which can include rolling hills and caressing breezes, so there is always a chance that our caution proves to be unwarranted. But our advice is to protect capital, because what matters is losing as little as possible when times are bad to have as much working for you when things get better.

To this end, investors should prize income, excellent value, short duration, and rapid payback periods. They should avoid high beta shares, those with prices that can be largely or more than fully explained by overall market moves, and they should avoid financial leverage. We believe this remains a time to play defence.

Hugh Selby-Smith is Co-Chief Investment Officer of Talaria Capital. Talaria's listed funds are Global Equity (TLRA) and Global Equity Currency Hedged (TLRH). This article is general information and does not consider the circumstances of any investor.

Thinking small to win big

Sinclair Currie

Conventional wisdom suggests that 'time in the market' is a less risky strategy than 'timing the market'. Boom and gloom provide attractive entry and exit points but only if the timing is right. Accurately identifying market peaks and troughs is notoriously difficult. In our experience, gradually allocating more to markets during times of market distress and less when 'everything is awesome' is a preferable approach.

Small caps, and in particular, industrials, present an opportunity for investors at current levels. The Small Ordinaries benchmark has underperformed the ASX100 since November 2021. Notably, industrials have underperformed resources, which have been supported by thematics such as energy security, battery materials, and gold. In addition, adjusting to tighter monetary policy has weighed on small industrials. The recent underperformance presents a chance for investors to incrementally allocate to the sector.

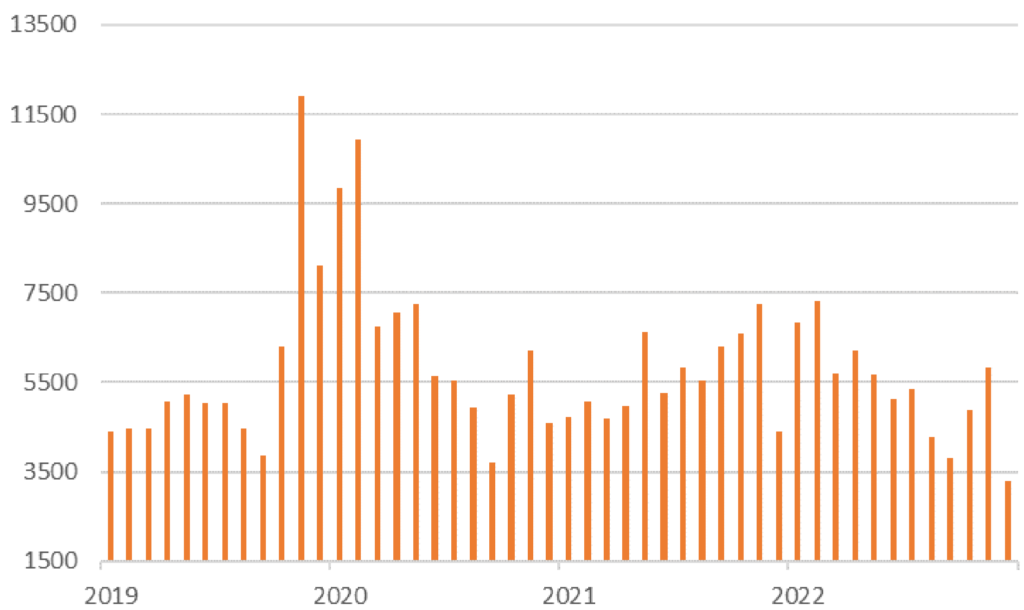
Small Ordinaries relative to ASX 100

Source: Novaport Capital, IRESS

Falling liquidity signals capitulation

Investors' willingness to trade reveals their confidence, or lack thereof, in the market. Rising liquidity can create a virtuous circle during a bull market, when abundant liquidity entices more capital into markets (attracted by lower trading costs). Yet when liquidity falls and markets are falling, the cycle works in reverse. Capital ceases to flow to (or exits) the market due to illiquidity concerns.

Small Industrials Quarterly Share Turnover (million shares)



Source: Iress

Since November 2021, liquidity in the small industrials sector has dropped meaningfully. In 2023, the daily average value of turnover for small industrials has been $704 million, down a third (from $1.07 billion) during the same period in 2021. The decline in liquidity indicates that a lower amount of new money is being put to work in Small Caps. Contrarian investors have a better chance of picking up a bargain now, relative to last year.

Microcaps have been hit hardest

Not surprisingly, the decline in liquidity has been most pronounced for the smallest of small caps. 74% of the smaller small industrials (with a market capitalisation of less than $1 billion) had lower turnover in the last 12 months relative to the previous year. Adjusting for stocks which benefited from index inclusion, 85% of companies saw turnover decline. The impact on liquidity has been lower for the larger small companies, 63% had lower turnover (or 69% adjusting for index changes). Unsurprisingly, 37% of 'larger' small caps (market cap >$1 billion) outperformed the benchmark relative to a mere 14% of the 'smallest' companies.

	Market Cap	
	Over $1bn	Below $1bn
YTD turnover lower relative to prev. year	63%	74%
**Adjusted for stocks benefiting from benchmark inclusion*	*69%*	*85%*
% of stocks outperforming small cap benchmark	37%	14%

One of NovaPort's holdings, Quantum Intellectual Property Ltd [ASX:QIP], provides a case study of the current dynamic in microcaps. Quantum has a meaningful and growing share of the Australian Patent, Trademark and IP Legal Services market. Over the last year, its share price has fallen by 19%, materially under-performing the small cap benchmark. On our estimates, the company trades on an attractive discount to earnings and yield metrics relative to the broader market, however its share turnover is 23% lower than the previous year. In a recent market update, the company reaffirmed expectations for organic growth, improving margins and further consolidation opportunities. The decline in liquidity merely reflects that the stock has fallen off the market's radar in our view, creating an investment opportunity. Quantum is just one example of similar opportunities arising in the current market environment.

Different exposures than large caps

The Australian stock market is heavily weighted towards highly profitable bank and resources stocks. The smaller end of the market has a wider range of exposures, from resource exploration stocks and retailers to fast growing technology businesses. The composition of the small caps benchmark evolves over time. Furthermore, industrial companies are less risky than three years ago. We estimate that loss making companies are now only 5% of the small industrials' universe, down from over 30% before the pandemic. The current small cap market has a lower exposure to risky, early stage, or loss-making companies.

Following the recent underperformance of small caps, we see attractively priced opportunities relative to the large cap universe. For example, Domain Holdings [ASX:DHG] offers faster growth than REA Group [ASX:REA] (as it increases market penetration), yet it trades at a discount. At the same time, small cap building materials companies in markets with high barriers to entry, trade at through cycle earnings multiples in the mid-teens, despite having more favourable industry structures relative to historical averages.

Smaller companies have traditionally been more volatile and sensitive to the economic environment, which is expected to be challenging. There are valid reasons to be cautious. However, the small industrials benchmark is comprised of more robust businesses post the 2022 market correction. Its underperformance relative to large caps and the withdrawal of liquidity suggests the market is already fearful. This presents us with an opportunity to increase our exposure to quality, but overlooked, businesses.

Sinclair Currie is a Principal and Co-Portfolio Manager at NovaPort Capital, a boutique Australian equities investment manager specialising in small and microcap ASX-listed companies. This article is for general information only and does not consider the circumstances of any individual.

Five steps to become a better investor

Andrew Macken

The sentiments of three-time world Formula One champion, Niki Lauda, live permanently in our minds: "From success, you learn absolutely nothing. From failure and setbacks, conclusions can be drawn."

But what conclusions? What lessons? Indeed, what should even be measured to evaluate success, versus setbacks or failure?

Below are five unambiguous truths that will help investors answer these questions:

1. Think in terms of probabilities

We humans tend to guess what the future holds. And we can hardly be blamed. An increasing body of evidence from neuroscience suggests the human brain learns by constantly making predictions about the world, which are subsequently updated by what we observe.

But investing requires a different approach.

Rather than guessing what *will* happen, we are better off assessing what *could* happen. Then, for each of these possible scenarios, assessing the likelihood (or probability) of it happening.

This 'probabilistic' approach helps investors better understand, and frame, the calculated risks we take.

Contrast two of Montaka's investee companies: Moderna and S&P Global, for example.

While both have merit as investment opportunities, they could not be more different in terms of their probability-weighted range of possible outcomes.

The range of possible outcomes for Moderna is very wide. If the company's world-leading mRNA technology can be used not just for COVID, but also for the seasonal flu, RSV, and various personalized cancer vaccines, then the upside in shareholder value is multiples from current levels.

But these use cases are far from certain. And if Moderna's vaccines prove to be ineffective, then there could well be significant downside in value from current levels.

Contrast this wide range of outcomes with a far narrower set of possibilities associated with S&P Global – a much more predictable business that is tied more to the size of the global economy. Growth is reliable, profit margins are stable and there are likely fewer surprises on the horizon.

This framing – characterized by the range and probabilities of possible outcomes – helps assess how much capital to place at risk.

Montaka's investment in S&P Global is much more significant than its relatively small investment in Moderna. This limits downside potential, while still allowing for participation in meaningful upside scenarios.

2. Extend your time horizon

Students of finance theory are taught that businesses are valued on the cash flows they deliver to shareholders into perpetuity. And yet, well after they graduate, many of these students focus excessively on what the next 3, 6 or 12 months holds for a company … though this accounts for a tiny fraction of its total value.

Even today, many investors are focused on whether the Fed might change its policy rate by 0.25%, or not, in the coming days or weeks. Or whether the US will be in a technical recession over the next six months.

Many stock analysts spend a disproportionate share of their time analyzing last quarter's results and forecasting the next.

This tends to lead to a subconscious overweighting of the importance of the near-term, at the expense of the much more important longer-term.

But the great investments are often determined by long-term realities (relative to expectations). While the short-term realities of the day turn out to be overwhelmingly irrelevant.

So how does an investor overcome this short-term bias? Extending one's time horizon is an approach that delivers two key benefits to investors.

Firstly, it increases the probability that you will make money. The table below shows that the longer your time horizon, the more likely you are to make money investing in equities. Over the last 125 years, 96% of all 20-year periods have made money.

Percent of Time Periods that Make Money

Based on last 125 years of Dow Jones Industrial Average

3 Months	1 Year	10 Years	20 Years
61%	71%	86%	96%

Source: Bloomberg; Montaka

A second benefit to extending one's time horizon is that it helps focus our attention on the most important things, such as competitive positioning and earnings power in 3-, 5- and 10-years' time. (Or in more precise probabilistic speak: the ranges of possible competitive positions and levels of earnings power, coupled with their respective likelihoods).

3. Tune out the noise

A liberating benefit of a long-term focus is that the endless short-term gyrations in news flow and market movements become less relevant.

Of course, this is easy to say and hard to do. We are wired to overweight recent facts and over-update our prior forecasts based on the persuasive narrative of the day. But this is often a mistake.

As mentioned, businesses are valued into perpetuity. That is, present day value reflects all cash flows that shareholders are expected to receive, not just this year, but for the rest of time.

Investors should make a list of the really important long-term drivers of value and try to stay focused on these things. At Montaka, for example, we are focused on drivers including: (i) sources of advantages, and trajectories; (ii) current and future potential market sizes and sources of growth; (iii) unit economics of selling incremental products or services; and several others. And we continually evaluate these relative to expectations that are implied by current stock prices.

4. Run your own race

Many years ago, I was a national champion in the unusual sport of orienteering. And in orienteering, staying focused on your own race is vital to success.

When navigating through a forest, it's tempting to follow the direction, or route-choices, of other athletes. But this can be very costly if they lead you along the wrong route – which inevitably happens. You always need to 'run your own race', even if it means making different choices to other athletes in the moment.

And it's no different in the sport of investing.

There's a saying in investing that: "If you aren't misunderstood, you have no edge." To invest well, you need to be different to the market, and you need to be right.

Why? Students of finance will be aware that stock prices are simply numerical representations of the set of expectations for the key value drivers of a business that are implied by the market. Therefore, if you expect what the market expects, it is already 'priced in' and you cannot outperform. Instead, you need to believe a different view to what the market believes (and you ultimately need to be right).

Of course, being different and misunderstood is often uncomfortable. But remind yourself: this discomfort is necessary.

5. Measure yourself objectively, and evolve

In a recent podcast, Professor John Vervaeke from the University of Toronto defined the concept of 'implicit learning' – learning that we aren't aware is happening – that informs our intuition. "You're picking up on very complex patterns without explicit awareness or deliberate effort," he said.

The human brain continuously and subconsciously sharpens its intuition over time.

But there is a peril to this process, according to Vervaeke: "Implicit learning doesn't care what patterns it picks up." That is, the brain does not distinguish between real causal patterns, and correlational patterns.

You know how close to stand to somebody at a funeral, for example. You've picked that up somewhere along the way, though you don't know where, when, or how. "So you just get the intuition," sayd Vervaeke, "And you do it, and you're right."

But sometimes our honed intuitions are not right. Our 'biases' – including our overweighting of short-term information – are unambiguously flawed.

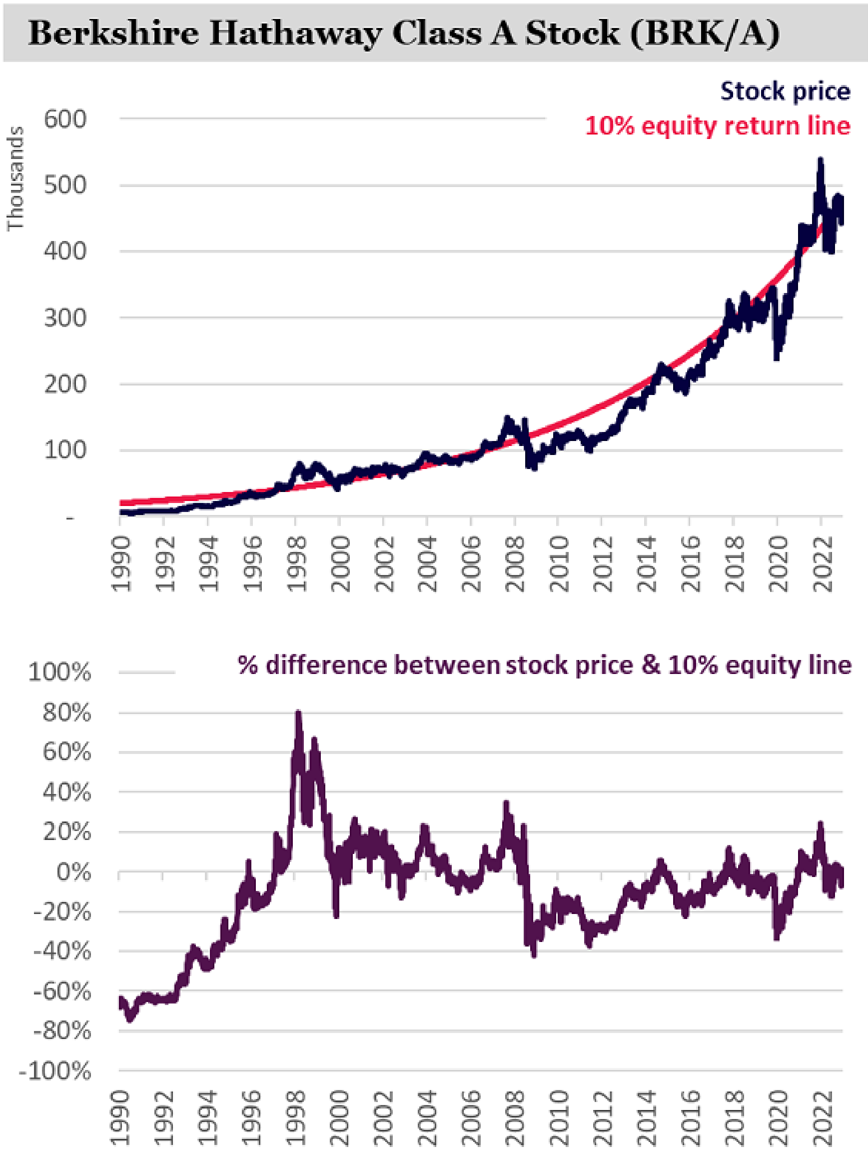
Unfortunately, the world of investing is flooded with complex correlational patterns that often lack true causal relationships. And stock prices are a big culprit.

Great analysis can frequently result in investment loss, particularly over short periods of time. Conversely, there are frequent instances of poor analysis resulting in investment gain.

This happens for several reasons. One relates to equity market inefficiencies – that is, deviations between stock prices and intrinsic value. Many factors drive these, from index funds, to monetary policies, and even social media.

Another simply relates to luck. Your analysis might suggest a 90% probability of gain, and 10% of loss – and you will lose one in ten times, by definition, despite the risk/reward ratio being fantastic. Alternatively, your loss – measured at a particular point in time – might simply reflect an unpredictable stock price journey over time towards an ultimate gain.

Take a look at the stock price of Warren Buffet's Berkshire Hathaway over the last three decades below. If one were to assume that today's price is fair value, and Berkshire investors typically expected an average 10% return each year, then we can infer the extent to which Berkshire was undervalued and overvalued over this time period.



Source: Bloomberg; Montaka

Putting aside the precision of the above assumptions, what stands out clearly is that, even Berkshire Hathaway – one of the world's most widely-followed and highest quality businesses, experienced periods of over/undervaluation that were both significant and persisted for years at a time.

The implication of these observations, therefore, is that investors are at considerable risk of learning the *wrong* lessons from time to time.

The solution here, according to Vervaeke, is to measure yourself with clear, objective, measurable information that is tightly coupled between cause and effect. Measure your fundamental forecasts (taking into account your assessment of possibilities and probabilities), not stock price returns, for example. Measure your adherence to process.

All investors are on a journey. Just keep evolving.

Andrew Macken is the Chief Investment Officer at Montaka Global Investments, a sponsor of Firstlinks. This article is general information and is based on an understanding of current legislation.

For more articles and papers from Montaka, click here.