Firstlinks

Connecting investors with ideas

Firstlinks Interview Series

A collection of the year's interviews published by Firstlinks

2020

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Introduction

Graham Hand

One of my favourite parts of editing Firstlinks is learning more about products and businesses in our Interview Series.

They are highly popular with our readers as they go beyond the marketing messages to identify investments or styles from leaders in the industry. We often allow the interviewee to mention their own products as readers need to know where to go to find out more. This year's collection of 21 experts covers most asset types and is a window into how portfolios can become more diversified to manage risk.

From the start of Firstlinks (previously Cuffelinks) in 2012, we have focussed on the insights of market experts on investing, superannuation and many social and demographic issues. Our audience now totals about 80,000 Monthly Active Users making over two million pageviews a year. The first year of Morningstar ownership has provided additional resources and distribution reach. Our website includes a searchable archive of over 3,000 articles.

These interviews have not been 're-edited' and should be read in the context of the date they were written.

Thanks to our sponsors who enable Firstlinks to be distributed free to subscribers and other readers. Please share this free ebook with friends and colleagues and encourage them to subscribe to our weekly newsletter for more great insights over coming years.

Cheers,
Graham Hand
Managing Editor

Tony Togher on why cash isn't just cash

12 February 2020

Tony Togher is Head of Short-Term Investments & Global Credit at First Sentier Investors, which is responsible for about $60 billion of client investments. He started his career in 1983 in the Commonwealth Bank's Global Treasury Division and moved to Commonwealth Investment Management in 1988, which was part of the merger with Colonial First State in 2002. In 2012, Tony was appointed to the Market Governance Committee of the Australian Financial Markets Association (AFMA).

GH: What has been the biggest change in cash and liquidity management since the GFC?

TT: The trade-off between liquidity and returns has become a major part of decision-making. Before 2008, little, if any, margin was attributable to illiquidity. Investments like RMBS (*Residential Mortgage Backed Securities*) were paying single-digit margins above swap in mid-2007, as were long-term floating rate notes issued by banks. But they offered poor liquidity making them a buy and hold. Diversification was an important part of portfolio management but liquidity was often ignored.

We learned in 2008 that the requirement for liquidity should never be underestimated, especially its unavailability in times of severe stress.

GH: When the market for many securities simply closes.

TT: Yes. So now we have more decisions to make. For liquidity-style portfolios, exposures must be to securities which always have the best liquidity (we call it 'omnipresent'). Or, we can determine that a proportion of a cash portfolio can accept less liquidity, but we want to be paid for that.

GH: You need to be rewarded for less liquidity with better margins.

TT: I say to clients that we have a 'liquidity component' versus an 'income component' of a cash book. Some of the income securities do not have the same level of liquidity, and we benefit from our experience with the counterparties for various securities.

GH: Do all banks buy back their own securities to give investors liquidity?

TT: Usually, but it's best endeavours, they don't need to buy, but they want to honour the liquidity 'contract' and maintain a market in their own paper.

There is also now a clear distinction between a bank term deposit and a bank NCD (*Negotiable Certificate of Deposit)*. It's exactly the same credit and exactly the same term, it's exactly the same issuer under the Banking Act, but one has liquidity and the other doesn't. What price for that liquidity?

GH: And bank issuers are willing to pay more on TDs than NCDs?

TT: Yes, because bank liquidity regulations give the TD a benefit to the issuing bank. But for us as an investor, a TD is not 'repo-eligible', so we cannot sell to as a repo (*Editor Note, a sale and repurchase agreement generates liquidity for an agreed term*). And a second-tier bank outside the four majors will pay extra on a TD, tens of basis points depending on the institution, their credit rating and the tenor.

GH: The four majors all trade at the same rate?

TT: Yes, although we all know that of the $120 billion or so of NCDs on issue by the four majors, none of them could buy back all their paper tomorrow, but their NCDs are the undoubted liquidity in the market.

There are rarely questions about credit limits for the four major banks (and Treasury Notes if available) and everything else trades at a margin. This was one reason why the Council of Regulators reshaped the BBSW pricing metric to derive from transaction activity as opposed to simply posting bid/offer spreads where 10 or 12 providers were involved. We no longer have dealers simply transacting at BBSW, and all transactions are now negotiated with reporting obligations. So the transactions undertaken *form* the BBSW price.

GH: What other scope is there for extra investment returns?

TT: Well, an innovation we helped to develop resulted from the introduction of the Liquidity Coverage Ratio in 2012 and into 2014. New rules were imposed relating to the liquidity capital requirements banks must adhere to for all assets maturing in 30 days or less, so the non-call deposit developed, moving the maturity outside that window. Then these products moved from 31 to 35 days as banks worried about the one day 'cliff risk'. Then came the Net Stable Funding Ratio rules in 2018, where structures allowed a conversion into a longer-dated security after a call. This instrument gives liquidity through the converted security (normally NCDs).

GH: Do investors think about cash differently in the last dozen years?

TT: From a funds management perspective, the notion that cash is a temporary place while looking for a better opportunity has changed. For example, in 2007, many investment funds had a cash allocation of zero because they wanted to fully allocate into higher-returning asset classes. But post 2008 they realised they needed cash because there are a wide range of circumstances where cash is required to facilitate a transaction.

For example, on cash-collateralised derivatives, where counterparties must put up cash due to the change in the profile of a currency hedge. Every insto now monitors credit risk exposure on derivatives and may require a cash top-up based on the mark-to-market. There's much more focus now on reducing the credit risk inherent in any transaction.

GH: In the $60 billion or so of securities you hold, how do you assign between the income and liquidity portions you talked about?

TT: The trade-off is usually specified by the client. A client with good insights into their cash flow forecasting may allocate more to the income space. We also run pool products where we make an assumption on what is appropriate for most investors.

GH: Can we turn to the funds you have available to retail investors including SMSFs. What's in your Wholesale Strategic Cash Fund, available on many retail platforms.

TT: The dominant securities are NCDs of major banks. There is also an allocation to term deposits and convertible deposits (which convert to an NCD upon call) and Treasury Notes. There are floating rate notes, largely issued by banks but some corporate securities, and an allocation to triple-A mortgage-backed securities.

GH: And what return does an investor earn at the moment?

TT: It's about 0.5% above the cash rate on a gross basis, then depends what fees the platform takes. The gross running yield today is about 1.25%.

GH: You're also responsible for global credit, so same question, what returns does an investor achieve on the Wholesale Global Credit Income Fund at the moment?

TT: It holds about 440 global securities and the goal is to swap back all returns to Aussie dollars and floating rate (*Editor note, short duration risk, not long term*). It's a widely-diversified allocation to global credit, given credit in Australia is highly concentrated in the financial sector. Our goal over time is to achieve a gross return of 90-day BBSW plus 150 basis points (1.5%), and we've achieved 157 basis points (1.57%) annualised over 20 years through the cycles. It has an allocation to both investment grade and high yield.

GH: How do you decide the high yield allocation?

TT: It is dynamic. It can be up to 25% of the fund or as low as zero. I believe we have better insights and the ability to provide value in that sector than most of our clients. Simply put, as yields compress we tend to become far more selective, and as yields expand, we allocate more. It's not a trading mentality, it's more a 'value-for-risk' allocation. The gross running yield is about 2.20% at the moment.

GH: Do you see much 'reaching for yield' in your space, the quest for yield at the expense of quality?

TT: Yes, some people have been more willing to take on credit or illiquidity risk to achieve a higher return, but credit margins are not at historical lows. They were lower prior to 2007. Indeed, high yield is not as tight as it was in December 2018, since then it has moved out from about 300 to 380 over swap. In fact, during the Fed tightening phase in 2018, it blew out to over 500. It's also moved out in recent days due to the coronavirus implying a higher likelihood of default. It's a volatile spread and a manager must be very diligent in allocating capital to the sector. As a chart on default rates shows, investors should recognise that lower-rated issuers will have more defaults over time.

Sources: S&P Global Fixed Income Research and S&P Global Market Intelligence's CreditPro®.

It's also important to focus on 'loss-given-default', that is, how much of your money you get back after default. There might be a default, but you get back 50% of your money.

GH: How long will cash rates remain below 1%? Is it five or 10 years?

TT: I don't think it will be a short period of time. The central bank accommodation is designed to re-inflate the economy, and the first sign of that happening will be wage inflation. Globally, I don't think having spent a decade trying to generate activity that central banks will rush to the table to stymie inflation. Anyone waiting for adjustments in rates upwards will need to be very patient.

GH: I have known you for over 30 years. One of the things that you say is that in this business, there are no degrees of honesty. What does that mean to you?

TT: That was a quote I heard when I joined the Commonwealth Bank as a fresh-faced new employee in March 1983. It always stuck with me as a truism. I've used it as a guide to what I am doing. Are we being open and honest? Would we be happy for this to be public knowledge? We are fiduciaries of client money.

GH: Final question, after nearly 40 years in a similar role with one company, what motivates you to continue?

TT: I guess the role is never similar, it evolves as dynamic markets change. I've worked with interest rates in the high teens and now sub 1%. This market is never boring, and the requirements of clients and investors are always changing. It's a constantly-evolving process.

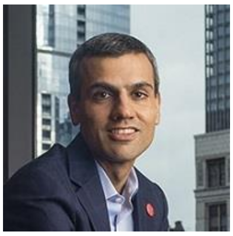
Graham Hand worked with Tony Togher in various roles including at Colonial First State before the platform and investment functions were separated. The funds management business became Colonial First State Global Asset Management, and following the sale by Commonwealth Bank to Mitsubishi UFJ Trust and Banking Corporation, it changed its name to First Sentier Investors, a sponsor of Firstlinks. This article is general information and does not consider the circumstances of any investor.

Kunal Kapoor on different paths to investor success

26 February 2020

Introduction: Kunal Kapoor, CFA, is CEO of Morningstar. Prior to taking this role in 2017, he served as President, responsible for product development and innovation, sales and marketing, and driving strategic prioritisation. He joined Morningstar in 1997 as a data analyst and has served as Director of Mutual Fund Research and was part of the team that launched Morningstar Investment Services, Inc.

Morningstar, Inc (NASDAQ:MORN) is a global financial services firm headquartered in Chicago, Illinois, United States and it currently has a market capitalisation of about USD7 billion (over AUD10 billion).



GH: You run a publicly listed company, but its main aim is to empower investor success. Can you give examples where you've had to reconcile differences between various stakeholders?

KK: We certainly have situations where we have to reconcile the way we work, such as the independence of our analysts when some clients have opinions on what our analysts ought to be saying. But when I was an analyst, I had carte blanche to deliver whatever opinion was researched and thoughtful as long as I could defend it. And I certainly delivered opinions that from time to time upset our clients.

GH: And maybe the commercial interests.

KK: Right, but it's no different today. Our analysts have the independence to say what they want to as long as it's well researched and thoughtful. Now I'm on the other side of the fence, I receive calls when people are mad. And I listen to them, but I cannot tell the analysts to change their opinions. In fact, I had one just in the last week where a CEO was upset with something and I was not able to pacify the individual. But I don’t change the language. I may ask the analysts to double check their work to ensure it is factually correct, but an opinion is an opinion.

As a public company, we operate very differently. We have a strong belief in democratising investing. In 2005 when we became a public company, we did an auction IPO (*initial public offering*). Everyone had access to it. We do not talk to any analysts or researchers during the year, except at our annual meeting when any investor can attend.

GH: So as a CEO, you don't do regular roadshows to investors or meet major shareholders in private?

KK: None of that. We don’t do earnings estimates, but nor do we do earnings calls. We set up our company for the long term, taking inspiration from people like Warren Buffett. It goes to the heart of what we believe around fairness and democratisation of the investing process. We answer questions monthly in regulatory filings. People can send us questions and we take time to answer these questions.

GH: Is that linked to something you say that a company gets the shareholders it deserves?

KK: Yes, I always say that. If you're managing the business for the short term, you're going to attract people who are chasing short-term returns. But if you are clear about how you want to operate and the rules you set up, you will get the right set of investors. Plenty of investors understand that management's time is better spent running the business versus spending time on road shows.

I believe the markets are efficient over time and that the value of a company in the public markets reflects the discounted value of future cash flows over periods of time.

GH: Do you say to investors, 'this is the way we run the company, if you don't like it then don't invest'.

KK: Yes, I’m totally comfortable to say that to people. I love that some of our largest institutional investors have been long-time shareholders for a decade or more.

Reaching all investors

GH: How is Morningstar addressing the fact that most of our engagement is either with financial advisers or sophisticated investors but the majority of people who probably need guidance are not receiving it?

KK: It's a challenge, but as someone who loves investing, it took me a long time to appreciate that many people are not particularly interested in investing. They don't live and breathe it in the way we do. So you have to meet people where they are. For us, that's meant doing things such as having a robo-adviser business, Morningstar Retirement Manager, in the 401k (*US retirement saving*) space in the US.

That's a perfect example of where somebody may not have much interest in investing, but they are looking for a thoughtful, fantastic long-term option that will help them reach their goals. We can reach a larger audience like that.

The other thing we think about is how to help younger investors. When you're young, you have a tendency to want to enjoy yourself, spending your money. But those are the years where you should lay the foundation for saving. Even if you're a great investor pumping out returns of say 100% a year, but it’s on a base of $1,000, it will not change your life. But for most of us, if we save well while we're young and we earn normal market returns, the power of compounding will work. But you need that base of savings.

Morningstar has a long history of using technology and design to explain financial concepts that sometimes come across as complex to the average person. We must make sure people feel information is accessible to them, which is why something like fund ratings are so helpful because they’re a snapshot that can guide their investment process.

GH: Do we need new ways of talking to younger generations? I sometimes feel my publication is too highbrow and we should have another at a different level with a younger voice.

KK: With any investor, younger or older, it must resonate for them before they will engage in an activity. For example, people approaching retirement have to figure out how they will live on their savings and pensions, they have a big incentive. But for younger people, it's hard to imagine what retirement looks like.

The most important way you can engage a younger investor is through the lens of personalisation. Technology allows you to personalise a portfolio in a more interesting way. For example, we have gone deeply into ESG because it makes investing resonate to more investors than ever before. You do ESG because you have a view of the future and you want your portfolio to succeed in a way that's aligned with the view of that future. It's not about what used to be called socially responsible investing, which is where people don't like tobacco or alcohol. This is about the future. You may believe that we're transitioning to a low-carbon world, so why would your portfolio not reflect that.

As transaction costs and barriers are coming down and people can invest with smaller amounts of money, they need to be educated. They need to understand why investing is important at any age, including help with behavioural biases that prevent a lot of people from being successful investors.

GH: Morningstar is devoting far more resources into behavioural coaching for advisers. What is some of the work being done there?

KK: We are modifying our software tools to include behavioural nudges that will help people reach better outcomes. There are some obvious wins such as making investors stick to a portfolio in difficult times, which is one of the most important ways to guarantee success. Or it can be more nuanced such as our new ESG preferences tool that considers the trade-offs being made in portfolios. Retirement tools can automatically encourage people to contribute more to their superannuation.

GH: Too many people buy at highs as the market rallies but sell after a market fall.

KK: Yes, sometimes it’s envy or the madness of crowds or getting scared by a headline. Ultimately, investing is about reaching a goal and sometimes doing less equals doing more for yourself. Anyone buying a financial product should ask what they are paying for and how it compares with what else is available. They should always ask about the incentives of the people selling the product, to understand how it fits into representing your best interests.

GH: Do you expect Morningstar employees to call it out if they see something in the market which they think is a poor product – for example, the wrong assets targeting the wrong people and too expensive?

KK: Yes, our analysts are often doing that in the fund space. Others should raise issues with the research team. Our ultimate goal is to empower investors and to make them successful and it's important to call out products we think are both good and bad.

All styles of investing have their merits

GH: Many active managers who have struggled to keep up with the index in a strong growth market have said that their day will come when the market falls and their quality will protect investors on the downside. Do you buy that argument?

KK: I personally believe active management has a strong case and passive management has a strong case. It's not like one versus the other, which is how it's often framed. I would reframe your question into a high-cost versus low-cost issue. If you're an active manager, your day is not coming if you're high cost, but there are plenty of good index and active options that will do well even in a bear market. And part of the reason they will do well is because they are low cost.

Good active offerings should be bought for the long term with expectations of periods of underperformance. That's the nature of the beast. Active management leads to some deviation from the index, hopefully, but are they doing things in the way they said they would, regardless of cycle? Are their incentives aligned to investors and are they doing it in a low-cost manner?

GH: If an investor chooses an active manager, how long do you believe they should persevere if there is a period of underperformance? Is it a 10-year decision?

KK: It's a personal preference, but three years is not long enough. They should give it somewhere between five to 10 years to judge properly. A deep-value investor may be in a five-year funk right now.

Supporting advisers and investors

GH: The financial advice industry is struggling at the moment with most advisers reconsidering their business model. What role do you see for Morningstar in helping advisers?

KK: For long-term advisers, it's a fantastic opportunity. Certainly, there's turbulence in the short run, but the end investor will win at the end of the day. The ecosystem will support them with great investment options, great advice and great tools. I view us as playing an important role in providing great research that people can use, taking the investment planning and linking it to their financial planning. We recently made the investment in AdviserLogic because as we think about how advisers work and their value proposition, they're under tremendous pressure because investors are demanding more value.

When you put together the pieces, advisers add a lot of value but they need to be thoughtful in the way they talk about it. ESG is a great topic when you talk about adviser value. For example, an adviser helping a retiree decide where to live 15 years ago would not have been looking at water tables in a seaside town. But now, part of the value proposition is the extra data that will help retirees consider what water tables may look like 15 years from now. It's a different decision given some of the changes that we're experiencing.

GH: The problems advice is facing with increasing compliance obligations and regulatory burdens, and the removal of vertical integration subsidies, means that full-service financial advice is increasingly for the wealthy. A lot of people are being left behind. There are quality advisers but it'll be for the top end.

KK: It's certainly true that's playing out exactly how you described it right now. But out of necessity is born innovation, and some of the advisers now serving wealthy households have not thought enough about newer business models. Today, adviser technology can automate parts of a practice so they can serve a midsize client more effectively and profitably than previously. It might take a while to shake out but I have great faith in the necessity, the technology and human ingenuity.

The Australian market is dynamic and firms like ours will step up and ensure that people get the advice they need. We must be open to the fact that it may not look exactly like what it looked like five years ago, but that's not a bad thing.

GH: One of the messages that Morningstar gives through Christine Benz, a thought leader in the business, is the priorities in an investment journey. She rightly talks about goals and saving and behaviour. Then she says, at the end, at the top of her of her pyramid, comes the investment decision and a legitimate way of investing is to hold some index funds. And yet Morningstar devotes considerable resources to fund and individual share research which may not be part of this journey.

KK: It's reflective of our culture that appreciates there are different kinds of investors. Christine is fantastic for onboarding investors who find investing is too complicated. She's thoughtful about what it takes to make investors successful particularly if they do not have a deep-seated interest in doing investing day and night. But she also recommends active funds as well. It's our way of saying there are different paths to success, and you can choose the path that you like best.

GH: It's a great way of communicating with people who may otherwise be left behind.

KK: Some people in Morningstar believe in 100% active and others believe in 100% passive and that's okay. The question is: does the portfolio that gets built ultimately measure up to the risk profile investors are seeking, and then ultimately does it get investors to achieve their goals? The only thing that matters is, does the investor have a successful outcome? Most investors don't sit around comparing results against benchmarks. They want to know if they have enough money to repay their college loan or take a vacation in Italy or buy that seaside home. That's what people care about. Success is hitting your goals and we should celebrate that.

This article is general information and does not consider the circumstances of any individual.

Vivek Prabhu on the volatility of bonds in changing times

18 March 2020

Vivek Prabhu is Head of Fixed Income at Perpetual and Portfolio Manager of Perpetual's Diversified Income Fund and Ethical SRI Credit Fund. This interview took place in mid-February 2020 before the full implications of coronavirus were known.

GH. Fixed interest and high-yield trusts have attracted billions of dollars of retail money in the last two years. What are the dangers an investor should watch in that sector?

VP: Obviously, the interest in high-yield trusts is driven by cash and term deposit rates paying less than 1%. The key risk factor in these products is whether they're concentrated in one sector. In credit markets, you're paid a premium to cover for default risk. It's a highly asymmetric risk profile. You receive regular and frequent small returns from interest coupons, but if the issuer defaults, you're exposed to potentially losing all your capital. It makes diversification really important, not only by company but also sector.

GH: What's a sector where some listed trusts are not diversified enough?

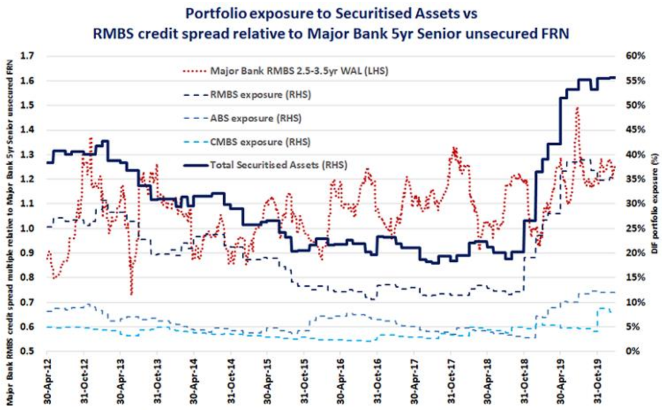
VP: For example, property construction and property development. Some trusts are offering over 5% but concentrated in a risky sector.

GH: Indeed, any retail investor who owned bonds issued by Axcesstoday which defaulted recently now knows that even if they held another nine bonds from other companies, that's not enough for portfolio diversification.

VP: Yes, there are not many free lunches in investing, but diversification is definitely one.

GH: Most asset classes have done well in the last few years. Would you identify anywhere in the credit markets that you think is either cheap or expensive at the moment?

VP: There are some good opportunities in RMBS (residential mortgage-backed securities). In the chart below, using the left-hand axis, the red dotted line shows the ratio of credit spreads on RMBS relative to senior major bank issues. RMBS gives a good pickup. Senior unsecured major bank paper is rated AA-, and there are only a handful of banks around the world which carry a AA rating, and Australia has four of them.



Source: Westpac, Perpetual

GH: Make sure I understand this chart. A multiple of 1.0 means senior unsecured bank paper trades at the same margin as a major bank RMBS, right?

VP: Yes. At the moment, prime RMBS earns a credit premium of around 100bp (1%) compared to senior major bank credit premiums in the low 70 basis point area (0.7%), but unlike the bank paper, RMBS is secured by the underlying mortgages as collateral. And so the RMBS gets a AAA rating. The benefit of the RMBS structures is that as homeowners repay the principal and interest on their mortgages, the bondholder receives some of the principal back.

It's very different to a corporate or bank bond, where the principal is repaid on maturity. It greatly reduces refinance risk because something is repaid monthly or quarterly. So not only is it higher rated and secured against collateral, you're also getting your principal back and a higher return.

GH: Yes, I personally own some RMBS and the regular cash flow is much greater than from a bond. You just have to record that the principal is no longer 100 on maturity.

VP: Yes, and the underlying risks in RMBS are similar to banks since residential mortgages make up over 60% of bank assets, plus with RMBS the underlying assets are in a more robust structure.

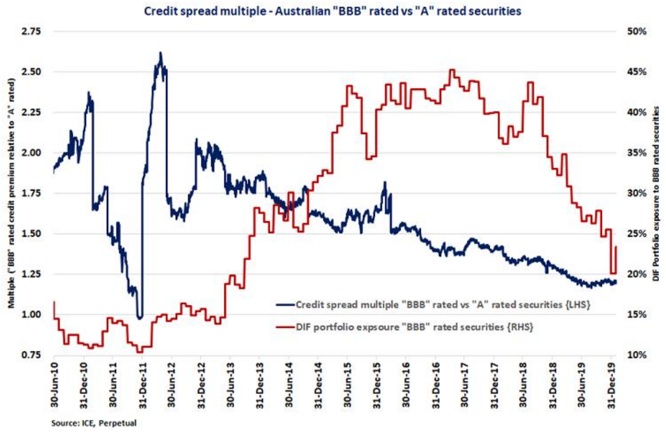
In the chart above, the dark blue line measured on the right-hand axis shows the percentage of my portfolio in all securitised assets and it's over half, currently 55%, which is a record high in the 15-year history of the fund. It's been as low as 20% when the relative credit spread was not as attractive. Since the end of 2018, I've been derisking my portfolio into quality securitised assets. The move up to 55% has been in lockstep with improving valuations as well.

GH: Are you buying the RMBS AAA class or also lower down the credit spectrum?

VP: Predominantly I'm in AAA but I am permitted to buy across the capital structure in RMBS and bank paper. Where I have reduced my exposure to fund the buying of AAA is by selling the BBB-rated securities. Look at this graph below which shows BBB credit spreads versus single A spreads. At the end of 2011, I had a low exposure to BBB (the red line below based on the right-hand axis), only about 10% of my portfolio. At that time, a BBB spread was equal to a single A spread (the multiple in the blue line measured on the left-hand axis).

GH: Again, a multiple of 1.0 means the BBB and A traded at the same margin, the blue line?

VP: Yes. At a multiple of 1.0, you're getting paid the same credit spread on A rated securities as you were on more risky BBB rated securities. The multiple has averaged 1.6 times over the last decade, and you can see it's been as high as 2.5 times.



Then in early 2012, BBB credit spreads blew out and so I started to add BBB exposure. Now, since that period, my exposure has gradually drifted down. My BBB exposure peaked around mid-2015 when BBB spreads were close to their long-term average and I held this overweight position until late 2018. Not only was the multiple attractive, but it was falling consistently, which benefitted portfolio performance.

But as I mentioned, towards the end of 2018, in August, September, I began to derisk in the portfolio. Part of the thinking was that central banks were aiming to withdraw liquidity from the financial system for the first time since the GFC.

GH: That's the late 2018 fall in the equity markets as well.

VP: Correct, a big risk-off time across all markets. My derisking moved into AAA senior secured amortising RMBS. But as we all know, in 2019, central banks did a big pivot, not withdrawing liquidity. And so the underlying catalyst for derisking changed, but notwithstanding I maintained the exposure to senior AAA asset backed and RMBS securities because the valuations were attractive.

GH: How much money is in the Perpetual Diversified Income Fund?

VP: Across the strategy, we have about $2.2 billion, and this Fund holds about $1.25 billion.

Going back to your first question on the fixed income risks, a lot of people who've chosen to maintain return (rather than accept lower returns for a given level of risk) have been chasing high yield or unrated bonds, but also pushing down margins at the bottom of investment grade (BBB). So I've been reallocating to the top of the credit spectrum.

GH: Last year, the Diversified Income Fund earned about 4% and the most recent running yield is 2.48%. Have the gains already been made in this sector?

VP: Well, if we look at the returns of that Fund over the long term, it has generated about two-thirds of its alpha from the running yield, or the credit premium, currently about 170bp above the bank bill rate. Plus we generate about one-third, or another 90bp, from active management strategies. So all other things being equal we could generate a gross return of 3.5%.

GH: Perpetual also has a listed credit fund, the Perpetual Credit Income Trust (ASX:PCI). What's the relationship between that and this?

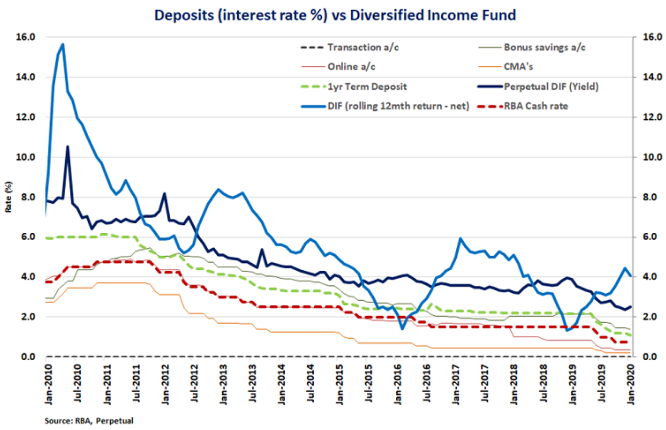
VP: Not a direct relationship in that PCI has a less-constrained credit strategy, whereas the Diversified Income Fund is predominantly investment grade with a target return of BBR plus 200bp (2%). The Diversified Income Fund requires a minimum 75% of the portfolio in investment grade securities of BBB or above. It's currently 91.7%. The PCI requires a minimum 30% in investment grade.

GH: How much change in credit spreads can the Diversified Income Fund tolerate before it starts to make losses?

VP: The portfolio has a maximum weighted average maturity limit the five years. Currently, the weighted average maturity is 2.8 years. And with a credit spread of 170 basis points (1.7%) above BBR, if you divide 170 by 2.8 years that's your 12-month break-even point on credit spreads. So we can afford spreads to widen by 60bp (0.6%) before we erode the credit yield premium. Looking at the total portfolio yield of 2.48%, credit spreads could widen by 90bp before you erode portfolio returns. And because it's floating rate, from an interest rate point of view, there is no meaningful exposure to capital volatility as interest rates go up and down because it simply affects the income generated from the portfolio, not the capital value.

GH: In SMSFs, there is still a large allocation to term deposits. Why have term deposit rates fallen so much recently, further even than cash rates?

VP: Here's a chart of cash rates, term deposit rates and the return on the Diversified Income Fund (light blue and dark blue lines). Cash is currently at 75 basis points (0.75%) and was subsequently cut to 50 basis points (0.5%) in March.



The green line dotted line is the one-year term deposit rate, which fell substantially recently. Part of the reason is that as we approach the lower bound of interest rates close to zero, banks are unable to pass on those rate falls to some of their deposit accounts which are already close to zero. It leaves the TDs to do the heavy lifting for the banks' net interest margin. The average today is about 1.2% for 12 months (which would be even lower following the 25 basis point RBA rate cut in March), so depositors are not even maintaining a real return above inflation (1.8%).

That's where a fund like the Diversified Income Fund plays a role. The dark blue line above shows the running yield of the portfolio, currently 2.5%. But 4% is the actual net return on the portfolio with value added by active management over the year.

GH: And on a mark-to-market basis, it looks like a loss in November and December 2018.

VP: Yes, from the widening credit spreads already discussed, we had a negative return in those two months. But the light blue line is a rolling 12-month net return, and over the last 10 years, the return has been below TDs in only 10 months in the period since 2010. That's 115 months of history and over 90% of the time, the Diversified Income Fund has delivered a rolling 12-month return better than term deposits.

GH: Is that after fees, and what are the fees?

VP: 70 basis points (0.7%) if someone comes in through Perpetual. Unlike term deposits, this Fund also offers daily liquidity, plus a positive real return.

Our active approach to credit investing is based on relative valuation, which is why we do this sort of analysis. Studying different credit ratings bands or different parts of the capital structure, allows us to identify where the best value is and where the risks are.

Perpetual Investments is a sponsor of Firstlinks. This article is general information and does not consider the circumstances of any investor. The margins and analysis are as at mid-February 2020, and since the interview, markets have experienced significant changes. Nevertheless, the general lessons in managing a fixed interest portfolio remain valid.

Rob Arnott on flattening the virus curve, not the economy

25 March 2020

Rob Arnott is Chairman and Founder of Research Affiliates and is widely regarded as a pioneer in unconventional portfolio strategies, including recognising the potential of 'fundamental investing', now commonly called 'smart beta'. He has published over 130 articles in distinguished academic journals and works to build bridges between academic theorists and financial markets.

GH: There's only one subject we can start with. How long do you think it will take for the US to get on top of the coronavirus pandemic?

RA: Look at what's happened in Taiwan, South Korea and Japan. These are modern, developed world democracies, not dictatorships, and they are dealing with coronavirus directly instead of crushing their economies. They are massively testing people, and if you want to be tested, you are tested. And if you test positive, they find out who you've seen in the last seven days and they test them as well. And whoever tests positive is put on strict and monitored home quarantine. The US and European answers are to close the economy and then throw money at it.

GH: People in Asian countries seem to accept the need to comply more readily.

RA: Yes, and the rules are mandatory and people can go to the hospital if they need to. But if it's just flu-like symptoms, don't waste more hospital resources in a time of crisis. If you step out of the house, you wear a mask and somebody will be there checking peoples' temperatures. And if you've got an elevated temperature, back to square one where you will be tested and you may be quarantined as we flatten the curve.

It's pragmatic and it doesn't intrude on the workings of the macro economy. Japan, as an example, yesterday had 36 cumulative deaths, but they've also had 3,000 less deaths from seasonal flu than they had last year. It's a silver lining, although 36 people died, 3,000 were saved.

GH: And 50,000 people a year die from the influenza in the United States.

RA: Exactly. And if this new virus kills 50,000 people, it would not be a surprise. So we're crippling the US economy for maybe a doubling of seasonal flu deaths. That strikes me as borderline insane. That's not a political statement about the current administration as both parties share the same policies. They want to crush the economy and then write cheques. It's astoundingly-badly run.

GH: Would Americans tolerate the personal intrusions?

RA: We have to look at the countries that are getting it under control and ask, what are they doing that we can borrow in a freedom-loving democracy? And the short answer is you can do pretty much all of the things they're doing. Not the command and control they do in China, but the things that worked well in those three countries.

GH: But take the example of Singapore. Anyone who comes in from overseas must go into quarantine and register their mobile phone number, and the location of the phone is checked and they receive a text message a few times a day which they must respond to. And to confirm they are in isolation at home, officials visit the house and check the phone hasn't simply been left there. In the land of free enterprise and individual rights, in both the US and Australia, would our societies tolerate such things?

RA: They might object to Big Brother knocking on their door multiple times a day, but they need to realise that aggressive actions are needed for a few weeks, and mandatory quarantine is the trade off to stop the spread. I hold to libertarian values and I'm a huge believer in human freedom, but that does not include the right to inflict lethal pathogens on your fellow citizens.

GH: Australia's approach is closer to Europe and the US than Singapore or South Korea, and our market is off another 7% today, taking it over 30% down because we are closing down the entire economy. There's no way back now. How do we avoid losing thousands of companies and millions of jobs and heading into a depression in both our countries?

RA: Yes, it's a government policy-inflicted depression that should have been a short, sharp recession. That said, if the government doesn't compound these missteps, it could still be a short, sharp depression. Goldman Sachs now estimates there will be two and a quarter million new jobless claims within a week, which would be an all-time record. I think they're sandbagging, I think it'll be more than that. In the next three weeks, we could see 10 million new unemployed.

In the US, 10 million people work in aviation, 14 million people in restaurants, and half of those jobs are gone. The numbers will boggle the mind. And both sides are trying to politicise it and blame the other party. Winston Churchill is credited with saying, "Men and nations behave wisely when they have exhausted all other resources." There's a lot of truth in those comments, but we'll find our way back eventually. Roll the clock forward five years and this will be a bad memory.

If that's correct, then sometime in the coming weeks or months, there will be a stupendous buying opportunity. I don't think we're there yet. The time to buy is when we're at peak fear. Right now, we're at 20% growth in infections per day. That's 10-fold growth every 12 days. If those numbers continue on that exponential growth curve, we go from 200,000 cases outside China to 2 million to 20 million in less than a month.

GH: Yes, we have trouble grasping the numbers. It's terrible that 10,000 people have died but the real issue is the growth path and the ability of the health system and resources to cope.

RA: Yes, when do we get it under control so that the growth starts to slow. People need to take personal responsibility, stay home, avoid crowds, wash hands, and we can sharply reduce the spread. If we're idiots, slowing growth might take more than a couple months.

GH: Do you really think there's a good chance of sensible behavior by enough of the 300 million Americans?

RA: Yes, but not quickly enough. We should post the National Guard at the entrances to stores and apartment buildings and offices and screen people using remote temperature gauges as they walk in. Anyone with a fever goes for a test. It's mandatory and if you don't, there's a big fine.

There's another angle. I'm in my mid-60s, which means I'm in roughly the 1% mortality range, I have a modest chance of dying from it. Okay, but I have one in 100 chance of dying this year anyway. People under 50 have about a 0.1% chance of dying from something else, people in their 80s have a 15% chance of mortality from coronavirus but they have about a 15% annual chance of dying anyway.

The way I look at it is, you have this health emergency, that seems likely to be temporary. It doubles your risk of dying in 2020 if you catch the virus. But we're destroying the economies of Europe, North America and Australia with the lunacy of these policies. The focus should be on taking people who are at risk and saying, "You do not have a human liberty to infect others."

GH: Research Affiliates is well known its long-term market forecasts. How will they change?

RA: When markets are down 30% plus, the forward-looking return is improved by 2% or 3% if all else equal. But all else equal is not equal, especially for industries such as airlines and restaurants and so forth. Other parts of the market will see widespread bankruptcies. The weaker players go out and that gives the survivors a clearer runway and less competition, and higher profit potential in the aftermath in recovery. And the government deficit spending has a one-to-one relationship with corporate profits, and the US will spend trillions on this.

GH: What happens to the US government debt to GDP ratio, which was already heading rapidly towards the north east corner of the chart?

RA: It will just get worse and worse until it breaks. It's like Thelma and Louise heading towards the Grand Canyon cliff. Everything looks fine until you go over the cliff. We're playing a very reckless game, and the end game is almost certainly be severe inflation to reduce the real value of the debt to a manageable level.

GH: How do you feel about the messages investment professionals give their clients to 'stay the course' and 'hold your investments', and then the market continues to fall each day? We said it at 10% down and 20% down and now it's 30% down. Should we modify these messages more towards taking the opportunity to rebalance portfolios into a more conservative stance? It's not a time for aggressiveness.

RA: Well, taking risk off the table was obviously better a few weeks or months ago than today. I don't harbour any illusions that I have a crystal ball, but the day of fear will come soon as people start to see how fast these numbers are growing. Then again, when the number of infections crosses a million, then when the deaths cross a quarter million. These things are all coming. The main thing, though, is to avoid doing stupid things in terms of our own personal health, for the sake of everyone.

From an investment perspective, you want to make sure that three months from now, you're ready and back to a 'risk on' stance. A year from now, I don't see this health emergency getting any worse. It's a 1% mortality rate for older folk based on the best-case study, the Diamond Princess, where everybody was tested. If this year, we wind up with as many people dying from coronavirus as from ordinary seasonal flu, that will shock a lot of people but it shouldn't.

This article is general information and does not consider the circumstances of any investor.

Citi's Gofran Chowdhury: clients don't think the worst is over

29 July 2020

Gofran Chowdhury is Head of Investment Specialists at Citi Australia.

GH: How have your clients changed their investment patterns over the past six months?

GC: Since COVID hit, investors have become a lot more conservative with their portfolios, they are looking for more certainty. Previously, investors were keen on exposure to equities, but now, there is more in fixed income. Our investors benefited from wider credit spreads when interest rates were higher than now. As the market recovered recently, their bond valuations rose, and they have invested more. We saw a 44% increase in fixed income investment in Q1 and Q2 of 2020 versus Q1 and Q2 2019.

People were also worried that interest rates were going to zero, so they locked in an income that pays say 3%. We also saw a big jump in term deposit investments even at low rates, including investors who sold their equity portfolio in February and March and were holding cash on the sidelines waiting for an opportunity.

GH: What's an example of the bonds they have been buying?

GC: The most popular Australian bond during COVID was Coles 2029 paying around 2.8% or 2.9%. At that time, term deposits were paying 1% to 2%. A lot of people realised, especially with the run on toilet paper and pasta, that no matter what happens, shoppers still need to go to the supermarket. We also saw demand for Dell 2026 and Dell 2029 offshore, as part of the technology theme around the fact that people are working remotely, using technology more. So another behaviour change we have seen is investors looking for names that will make money during a pandemic.

GH: And has that continued since the low of March?

GC: There was a change in May and June, when we saw some clients looking for investments that would perform well post the pandemic, the early enablers of the economic recovery, such as resource stocks like BHP and Rio. The thought process was the fact that once we come out of this pandemic, governments will move heavily on infrastructure investments, generating demand for resources.

However, more recently into July, the second virus wave in Victoria and other countries had an immediate impact that surprised us. A lot of investors started to buy US dollars as a safe haven currency and a diversification strategy, although they don't earn a lot of interest. They see the US dollar as a natural hedge to the Australian equity markets, so if there is a correction in equity markets, the US dollar tends to hold its value.

Our investors were also seeking US dollar investments in the fixed income space. It surprised us because traditionally Australians tend to invest in Australian names.

GH: But did your clients see March as an equity buying opportunity and participate in the subsequent rally?

GC: There has been a lot of talk about the rise of retail investors going into the stock market, and we did have some clients looking for growth assets. But more generally, our clients don't think that the worst impact of COVID is over. They certainly don't see a straight-line growth from here, so they were looking to protect the downside as well using tailored investments.

GH: Do your clients believe there is a disconnect between low bond markets and strong equity markets?

GC: Our clients realise the market is flush with cash, driven by liquidity. Central banks are pumping money in, and some clients are worried it will lead to inflation. I like to use the example of a chair with one of its four legs missing. Although you can sit on a chair which has three legs, it might be shaky. The fourth leg needed by the economy is the drugs and vaccines to control COVID-19. Until there is medical success, our investors are cautious of this rally.

GH: Tell us more about these tailored investments you mentioned.

GC: We take the client's view on the market and build something to back that view. Usually, they want certainty but they don't want to time the market. They don't think they are fund managers, but we build a predefined payoff that backs their view. An example last month was clients believing the market will rise over the next five years but they wanted downside protection over the first year. So we tailored a deal which participates in the upside and limits the downside.

Another popular one recently was built around the uncertainty of bank dividends, which are a big part of Citi's client portfolios. Even if the dividends go down, they want a consistent income stream. Sometimes clients ask for Citi's view and we build something around that. For example, Citi is bullish on certain tech sectors, so we have a payoff whereby a client can participate in 125% of the positive performance of tech giants Amazon, Apple and Google. The payoff enables the investor to get more than just the 1:1 return they would receive by buying the equity direct and on the downside have a 40% barrier to protect against volatility.

GH: In your wealth management business, have you faced the same issues as the big Australian banks with conflicts of interest in a vertical integration model?

GC: Our focus is on open architecture, so generally, we are not a business in Australia that manufactures its own funds management products. We've seen our friends in the big four struggle with that business model. We have a global capability to access securities which clients can't get from our competitors. For example, we have one of the largest spectrums of bonds and access to every issue we want. We distribute in all the markets Citi operates.

GH: What's the platform that your clients' investments sit on to make the administration and monitoring and management of those investments easier. Do you offer any of the major Australian platforms or managed accounts?

GC: Again, unlike our competitors, we have our own platform fully integrated with client banking, and we don't charge a platform fee. The reason we are able to do that is that the platform is the same for clients in Singapore or Hong Kong or wherever. Many clients invest and live in multiple geographies so all their wealth can be viewed in one place. Having said that, it does not have all the features and flexibility of some of the local players.

GH: If a wealthy couple comes to see you for the first time, embarking on an investment journey to finance say 30 years of retirement, what's the first question you ask? How does the conversation start?

GC: It's a great question. If someone's looking at a 30-year plan, first we want to understand if they're coming to us for investments or they're coming for advice. We don't provide personal advice, we operate in the wholesale investment space. We are keen to educate and give a good understanding of the markets, but we refer them to a financial planner externally for advice. We want our clients to be comfortable making their own decisions. So the first questions are normally about their knowledge and experience.

GH: Assuming a person understands a reasonable amount about the market and they've had some financial advice, how does the investment conversation start?

GC: We try to understand what problem the client is trying to solve and what is their view. We will provide the options. We operate like a co-pilot and the client is still piloting the plane. We don't make the decisions. Many of our clients are successful in other fields and confident making their own decisions.

GH: Last question. What is Citi's view on recovery from the pandemic and vaccines?

GC: Our base case is a U-shaped recovery. We think we'll be in these difficult conditions longer than many others expect. The adverse long-term impact on many sectors such as airlines and travel will be huge. We thought there would be a second wave and that is now happening. We've been impressed by the collaborative efforts from governments and central banks, both fiscal and monetary policy. There will be a lot of structural changes in future as well.

Gofran Chowdhury is Head of Investment Specialists at Citi Australia, a sponsor of Firstlinks. This article is general information and does consider the circumstances of any investor.

Will Baylis on dividends and accepting stock market risk

26 August 2020

Will Baylis is a Portfolio Manager at Martin Currie, a specialist investment manager within the Franklin Templeton Group. He is lead Portfolio Manager for the Equity Income and Sustainable Equity strategies and Co-Portfolio Manager for multi-asset portfolios.

GH: Martin Currie in Australia recently wrote to the chair of every major company in your income portfolios with the message, *'If your company has reasonable cashflows and a sound financial position, dividends should be paid.'* What have the reactions been?

WB: We've had remarkably positive responses. And in many cases, the chair has taken the time to write a detailed reply rather than just an acknowledgement. One chair of a large company said he had been writing about the importance of dividends since the 1990s. Companies receive up to 20% of their dividends back in reinvestment plans, and if they're worried about cash flow, dividend reinvestment can be underwritten for a small fee.

GH: And franking credits are of no value on the company balance sheet.

WB: Yes, they're unique to Australia and they belong to shareholders. This chair has always advocated that where companies have the means and reasonable capitalisation, they should pay dividends, but that doesn't mean dividends need to go up every year.

GH: Any other feedback?

WB: Another company, a large utility, attached our letter to the board papers. They've just announced that because they have a high free cash flow, they will pay special dividends next year. So, we are pleased with the letter and they said it was very timely.

GH: Last week, we saw ANZ pay a dividend, although reduced, while Westpac suspended theirs. What's the difference between these banks?

WB: Well, ANZ has a high level of capital and they acknowledged that they want to pay dividends, they have different types of shareholders and many rely on the dividends and have done since the GFC when interest rates have fallen from being quite meaningful to zero. Westpac has poorer trends with their bad and doubtful debts and made a balanced decision to hold back the dividend this time.

GH: Were you surprised that a company like BHP, which has had the benefit of strong iron ore prices, reduced its dividend a little?

WB: We hold BHP and we're happy that they paid a meaningful dividend. Whether it was 10% below or above consensus is not our point. BHP has enjoyed strong iron ore prices, they've got strong free cash flow and they paid what we call a meaningful dividend.

GH: Do you think a board should maintain a steady stream of dividends and in good years hold some back in expectation that future years might be a bit leaner?

WB: A board should be aware of their capex requirements for maintenance and growth and their operational costs, etc. If they retain more capital than they need, it has to be put to work. They will be measured against their weighted average cost of capital. If there is a poor marginal use of that capital by retaining it, it makes more sense to pay it to the shareholders. Retaining dividends should be linked to a greater or different purpose for that capital.

GH: In your income funds, what are you expecting on the income for FY2021 compared with FY2020?

WB: At this stage, we're expecting income on our Equity Income Fund to fall about 20% to 30 June this year. That said, the market's income is expected to fall between 30 to 40%. So we've tried to hold companies that have a higher probability of paying dividends with quality characteristics of free cash flow and strong capital positions.

GH: And how do you balance capital preservation with generating income?

WB: When you manage a strategy for income, you have two main objectives. One is to give dollar income to your investors from dividends and deliver a yield which is higher than the broader market. Our strategy is expected to deliver about 6% including the value of franking credits. So, if we can deliver that, we feel we've done a good job in minimising what we call a drawdown on income.

GH: Right, that's the income point of view. Is the capital outcome too difficult to predict in this market?

WB: We believe if we have a high-quality portfolio, with companies that have high barriers to entry, high levels of free cash flow, etc, over time it should give a lower level of capital volatility than the broader market. The Equity Income strategy has a beta since inception in 2010 of around 0.9. That is, slightly less volatility than the broader market. Rather than focusing on the total return, which is capital plus income, we find companies with a lower level of income drawdown because we feel we have more control.

GH: Given the pandemic has delivered winners and losers, with names like Kogan and Afterpay doing well and Flight Centre and Qantas struggling, have you made changes in the last three to six months?

WB: The interesting thing about owning companies in Australia with reliable dividends relative to the market is we tend not to own the Kogans and Afterpays of the world, and even CSL because it has a dividend yield of less than 1%. But we have made changes to reduce the income drawdown. We reduced exposure to energy, because we're worried about the oil price, and we exited Sydney Airport due to the closure of international borders, which we think will be a much more prolonged event than the closure of domestic borders. We've invested in some companies that have benefitted from COVID like JB Hi Fi, Coles, Woolworths and Harvey Norman. The government support and stimulus has helped some companies.

Another thing we did back in March was go through the entire universe to check which companies will have solvency issues and which will have a significant fall in revenue, because we don't want to own those companies in an income portfolio.

GH: What have your investors been doing in the last three to six months?

WB: The funds under management have been steady, we haven't seen outflows but we haven't seen significant inflows either. CBA recently reported a $15 billion increase in their term deposits in six months. That tells you that a lot of people are accepting 1% or below. Banks are now funded substantially by their own term deposits and people are holding a lot more cash.

GH: Although the equity market has done surprisingly well since March.

WB: Yes, but a lot of the big rises have been in a few technology or health names, whereas the companies that we own in our Equity Income portfolio have not done as well because of the level of uncertainty around the outlook.

GH: There are many different ways that people manage income funds. Do you use derivatives?

WB: Not at all. If you start using call or put option strategies to either boost income, which is basically close to dividend stripping, or alternately trying to protect capital, there's a cost to that. It's like an insurance premium, which has to be paid from the client's return. We focus more on the sustainable dividend with franking credits of each company over time.

GH: You recently wrote an article for Firstlinks on looking through the pandemic for quality companies even if you recognise they might have some short-term problems. How does that work?

WB: Look at the example of Transurban. Before COVID, Transurban had a history of growing its distributions by 9% to 10% per annum, but recently, it has reduced dividends markedly because the volume of traffic on its toll roads has collapsed. But we see Transurban as a really high-quality company, the dominant owner of toll roads and exceedingly well run. So we were tolerant in knowing Transurban would reduce its distributions while we are holding it.

GH: What about the Australian banks which many people have relied on for income?

WB: Well, three of the four banks are still paying a dividend, they all have high capital buffers, we know the banks are vital to the safety and security of the Australian financial system, so again, we hold all four banks in the Equity Income strategy. We're not at index weight and we knew dividends would fall but we're happy to hold them through the crisis.

GH: Transurban is an example I often use in presentations. When Sydney's Eastern Distributor opened, the toll was $3.50 and now it's $8. That's a lot of money for some people but that's pricing power for an asset drivers want to use.

WB: That's true, but to their credit, they've set up a division which focuses on customer hardship. It's a genuine attempt to provide relief for customers who can't afford the tolls.

GH: Final question. What do you say to a retiree who wants the income from shares but is worried about capital preservation - the risk/return trade off?

WB: I would suggest to your readers that they contrast the risk/return around term deposits with the risk/return of owning a diversified equity portfolio. On term deposits, the capital risk and income return are both close to zero. That will be the case for the next few years but most retirees can't live on a 1% return. Contrast this with say 6% including franking on equity income with a historical volatility of about 11% on the capital. That doesn't mean that every year, investors should net off the 6% yield against an 11% decline in capital. It simply means that over time, the capital value of the portfolio is likely to move up and down by 11% a year on average.

But for investors who can accept the 11% volatility, they still receive the 6% income. So they don't need to drawdown on capital if they have sufficient income and they don't need to worry as much about the implied capital volatility of the portfolio. The income comes in every quarter through the unit trust structure. For many, a 1% return is intolerable and a 6% return with volatility of 11% should be tolerable if they can rely on the income. Investors should think long term and hope to live to a very fine age.

Will Baylis is a Portfolio Manager for the Martin Currie Equity Income Fund. Franklin Templeton is a sponsor of Firstlinks. The information provided should not be considered a recommendation to purchase or sell any particular security. Please consider the appropriateness of this information, in light of your own objectives, financial situation or needs before making any decision.

John McMurdo and David Macri on ethical investing demanding more than fluffy answers

9 September 2020

John McMurdo is Chief Executive Officer and Managing Director and David Macri is Chief Investment Officer at Australian Ethical, a listed fund manager currently managing about $4 billion for Australian clients.

GH: A listed fund manager has multiple stakeholders. How do you balance them and what are the major metrics on the way you measure the business and your performance?

JM: Clients come first. Investment performance will always be the key test, we couple that with measuring client overall satisfaction using a Net Promoter Score. That includes both underlying investors and financial advisers. For shareholders, profit and total shareholder returns are key. But like all investment management companies, funds under management is important as it measures not only our growth as a company but also the growing impact our customers are having on the planet and people via how their money is invested. And culture is everything. We run an engagement survey with staff to test all dimensions of our culture. We apply to our own business the various tools we use to assess companies for our portfolios, including a focus on diversity and inclusion.

So balancing all those stakeholders is deliberate and we believe strongly in the interconnectedness of each measure, not just shareholder outcomes. It creates a whole that is better than the sum of the parts.

GH: Do your investors and shareholders invest with you because of your ethical position or for investment performance, or is it not possible to separate the two?

JM: We think people are attracted to us for both in some combination. Some invest for ethical reasons and enjoy the performance, while others want performance and are reassured by the ethics. We are showing you can achieve both.

DM: From an investment perspective, we don't like to separate those two things, it is just one process and one style. It doesn't work if we don't deliver investment performance and alternatively, if we're delivering investment performance without being true to the ethical charter, that's not what our customers want.

GH: But my ethics are not your ethics and your ethics may not be the same as your portfolio managers. How does this play out internally and what if a portfolio manager says, “I liked that company and you forced me to sell it and the price rose?”

DM: Yes, I agree, everyone has different values and it's impossible for us to manage based on individual values. So we have a principles-based Ethical Charter. It states 23 principles that we abide by. So yes, a lot of work goes into interpreting the principles and how we apply them to the investment universe. A portfolio manager would not get penalised for divesting out of a company on ethical grounds and then the share price goes up.

GH: John, I realise you've only been at AE for six months but is there an example of a value or principle that has changed, that was previously acceptable to the community but is no longer?

JM: My overall comment is that the Charter has served us well since inception in 1986. Take gender issues, for example. We are one of the significant minority of ASX300 companies to have 50% gender diversity at both board and executive management level. We have documented frameworks on screening companies for discrimination, lack of inclusion, harassment. So less has changed than more as we stick to our principles.

DM: We've always been true to our values and you can finally see other examples of that as mainstream fund managers and shareholders are holding boards to account on culture and behavior.

GH: We receive articles regularly from dozens of fund managers and it's common to position their businesses around ethics and sustainable investing and ESG. When they start an article with, “Sustainable investing has come of age”, it’s as if they've just discovered something. Doesn’t that make it a crowded space for Australian Ethical to stand above?

JM: There's no doubt the competitive landscape has changed as others replicate what we do. I welcome it. A deeper, stronger ethical investing sector will be good for clients and good for the world. But we have what I call ‘ethical authenticity’. Unlike competitors who may offer one or two sustainable options, sustainability and ethics are at the heart of our business and portfolios. It's all we do.

GH: I was chatting with John Pearce, CIO of UniSuper, and he said that if he disagrees with what a company is doing, he needs to decide if it is better to stay as a shareholder and influence them from inside the tent, or go for the big divestment headline and sell the company. What’s your view?

DM: The ideal scenario is where you engage, and attempt change in a positive way. But without the threat of divestment, you find yourself in a continuous loop of discussions and there's no real motivation for the company to change. You keep putting in the questions and the fluffy answers come back.

There must be progress and a motivating factor for them to improve something. You need a lot of shares in a company to really influence, so divestment elevates the issue, sometimes in the public domain, and creates some urgency. And we find that you don’t necessarily need to own shares to engage with a company, particularly if you’re a large institutional investor.

Corporates are always eager to speak to large influential investors.

JM: In FY20, we engaged with over 400 companies on environmental and people issues, and we believe at least 70 of those led to a genuine change. We take it seriously.

GH: In your results presentation, the average revenue margin has been falling for many years. Do you have a deliberate policy on reducing fees as you grow?

JM: We do, and we will continue. We're committed to making ethical investing as affordable and accessible as possible. It's an equitable balance between stakeholders so both shareholders and clients share in the success of our growing scale.

GH: And you also called out the 638 investors who closed their superannuation accounts under the pandemic early access rules. Do you have a view on people accessing super early?

JM: Yes, I have a couple of perspectives on it. First, we believe it's the investors' money, and if accessing it early helps their financial security, then we support it in these extraordinary times. But we're anxious to avoid it becoming a common event with super reduced to a glorified bank account. We all know the benefits of long-term compounding and we need to make sure people's futures are protected.

GH: Accepting that in the privileged position we're all in, we can't criticise someone who's struggling to pay off a loan or put food on the table. But a lot of success in the last six months of Harvey Norman and JB HiFi and Kogan is people withdrawing super and not spending it the right way. Do you think that this early access to super has been too easy?

JM: Hindsight would tell us that's likely the case, but I'm sympathetic to the government's need to take drastic and fast measures without the fine detail being perfect. With more time, they may have been more tailored than the policy that was rolled out.

GH: Your flows have been strong in the last six to 12 months, what type of investor is the money coming from?

JM: Yes, we've had 100% growth in net flows. It's a seismic shift in investor sentiment, where people want to see their money do well and do good. The research shows that two in every three Australians want to be certain that their superannuation and investments are not harming the planet. And 62% of Australians accept that ethical investing provides better long-term performance. We're seeing it across the age spectrum from younger millennials to middle age and older. Clients were more the younger demographic three years ago but it's now very broad.

GH: Is it adviser-led or direct?

JM: Both. A lot of clients come direct, but advisers are also saying they want to be on the front foot of the ESG change, investing in both the funds format and managed accounts on platforms. And if we see demand to deliver our funds in a different way, such as listed vehicles, we'll consider it, especially as technology improves.

GH: It's a strange market at the moment. Your own share price has a 12-month high of around $9 and a low of $2 and it's around $5 now. The headline in the *AFR* today says 'ASX rises 1.6%, GDP falls 7%'. What's your take on what's happening?

JM: There's a lot of looking through to the end of the pandemic, which we do too. The world is not going to end even if it will not go exactly back to normal. We'll still have great companies delivering great results, especially post a vaccine, but there'll be plenty of volatility still to come.

DM: Nobody likes seeing these dismal economic numbers, but the market is good at looking well ahead. We already knew we were in a recession, so the GDP fall wasn't news. We will definitely see a rebound although we don't know the duration of the downturn. So we look through it and come to a fundamental intrinsic value of a company that we hold. If they benefit from COVID, that's great. If they don't, is it an opportunity? We stick to our processes and the fundamentals of investing to construct diversified portfolios.

John McMurdo is Chief Executive and David Macri is Chief Investment Officer at Australian Ethical, a sponsor of Firstlinks. David did a recent review of 2019/2020 here. This article is general information and does not consider the circumstances of any investor.

Jordan Eliseo: Why it's gold's time to shine

16 September 2020

Jordan Eliseo is Senior Investments Manager and Head of Listed Products and Investment Research at Perth Mint, with over 20 years of experience in financial services. Owned by the Government of Western Australia and operating under an explicit government guarantee, Perth Mint distributes about $18 billion of precious metal products annually. Its gold Exchange Traded Fund (ETF) on the ASX uses the code PMGOLD.

GH: Many investors are looking for gold exposure, but how should they choose between the three alternatives of investing in physical gold, a gold ETF or shares in a gold miner?

JE: There are pros and cons to each. The easiest to separate from the others is the gold versus gold miner debate. It's a fundamentally different risk-return profile. While there are times in the cycle where well-run gold mining companies can be profitable investments, they're typically more volatile and higher risk because there are more factors in play. What's the size of their reserves? What's the grade? Do the locations of their mines give country risk and do they hedge production?

GH: And like any other company, the quality of the management.

JE: Yes, another reason why investors tend to allocate gold miners to part of the equity component of their portfolio. The 'bar or coin' decision versus an ETF comes down to whether the investor places some value on the physical nature of gold, holding that wealth in their hands and storing an asset almost outside of the financial system. Some in the investment community want that and are happy to pay a premium. They sacrifice a bit of liquidity storing gold in a private vault or at home as it cannot be sold simply on an exchange or back to a bullion dealer. If the investor really wants exposure to the gold price in a portfolio, then typically they gravitate towards an ETF, especially if they're already buying shares. It's easy to add to a portfolio alongside the rest of the shares or ETFs they own.

GH: When you say a gold bar comes with a premium, what are the costs involved?

JE: It's the storage and insurance and security of taking care of physical gold. From the refinery's or mint's perspective, fabrication costs go into making a bar or a coin. The larger the bar, the premium as a percentage will be lower than buying a very small bar or coin. However, investors go into a pool when buying an ETF and the spread is lower. For example, $100,000 into a gold ETF might include a buy/sell spread of 10 to 20 basis points (0.1% to 0.2%) but if you put $100,000 into one-ounce coins or bars, the premium might be 1% to 1.75% for a cast bar or minted bar, or 4 to 5% for a coin to cover costs.

GH: You've been closely involved in the gold industry for many years, including when interest rates were higher than they are now. Some people criticise gold saying it's not an asset because it doesn't produce any income. Do you find this criticism of gold is less common now that many bonds don't produce much income?

JE: Yes but it's not just the fact that there's no real income on bonds or term deposits. Gold is actually performing. If gold were falling in price, then earning nothing on a term deposit is better than earning negative on gold. And history backs this up the performance of gold in this interest rate environment. In the past, when real interest rates have been 2% or lower, gold has delivered about 20% per annum in nominal terms.

Why is that? One, the opportunity cost is low, but two, the reason interest rates are low is because the economy is struggling which over the cycle constrains company earnings. It makes sense that gold would outperform in this environment. And three, we should factor in the inflation argument. Interest rates could rise from here but if rates go up 1% and inflation goes up 2%, real rates have actually gone even lower.

GH: Do you think investors looking at an allocation into gold go through the same process as they might with other asset classes, such as 30% to Australian equities, 30% to global equities, 20% to bonds. So let's do 10% to gold. Is it thought of as an asset in that way?

JE: Increasingly, we see that, especially as SMSF trustees, financial planners and institutions allocate to gold. It's a nuanced asset allocation conversation on the role that gold can play in a well-diversified portfolio. In the past, gold was more an 'all-or-nothing' thing. But it's more sophisticated now and investors are asking about the pros and cons of this asset class. Many advisers now say 5% to 10% makes sense.

GH: As a permanent, long-term allocation, not only due to current conditions and low rates?

JE: My view is that every asset class has at least one negative attribute. There's no perfect asset class. In gold's case, the lack of income is less than ideal but it's always liquid and physical gold has zero credit risk. Its long-term returns stack up and it tends to outperform when rates are low or when equity markets are volatile. Those are the positives that make sense of an allocation.

GH: Are all gold ETFs essentially the same?

JE: It's a big subject and maybe we can cover in more depth another time, but here are three things to watch. One, who is the issuer? Two, what is the management fee? As gold is a purely passive asset class and the ETF tracks the price, any fees cut into investor returns. And three, what is the liquidity of the product?

GH: I was surprised to read how much Perth Mint is part of the production process of gold in Australia and how much goes through your refinery - including all those tiny nuggets dug up by individual prospectors plus the massive production by major gold miners.

JE: Yes, but to be clear, we don’t mine directly, we have relationships with miners, and small prospectors usually go through a local aggregator. The vast majority of the gold we refine is sourced within Australia, which is the second or third largest gold miner in the world in terms of tonnage of production, currently in excess of 300 tonnes which is about 10% of world output. We do source from other countries but that’s typically gold mined by an ASX-listed company. Perth Mint is the largest refiner of newly-mined gold in the world and we process the vast majority of Australia’s production.

GH: What about the collectible coin market. Is that an investment?

JE: It’s a good business but a small component of the overall gold market. In the 2019 financial year, our total turnover was $18 billion and coins, medallions and minted products were about $1 billion of that. So about 5% of our market. Collectible coins are a subset of that $1 billion. There's the gold content and the gold value or silver value of those products so it's a niche market with other things such as theme, innovation and uniqueness driving that market rather than the precious metal price alone. So for the vast majority of investors that want gold in their portfolio, they will buy bars or an ETF.

GH: Where does silver fit in?

JE: Perth Mint is a major refiner of silver and we have depository accounts that allow people to buy silver and store it with us. We manufacture silver bars and silver coins. Most people's first interaction with precious metals is gold, as it has more ‘brand name’ recognition and everyone implicitly knows gold is valuable. The role of gold in a portfolio is clearer, such as the correlation with equity markets and ‘risk off’ investing. Large investors who want to invest in precious metals will tend to stick to gold.

GH: Flows into gold ETFs have been strong in the last year. Besides the simple reason that the price is rising, how much comes from the currency debasement argument, massive amounts of government debt undermining ‘fiat’ currencies?

JE: To give some context, in the first six months of 2020, about 700 tonnes of gold went into gold ETFs globally. That was more than in any previous whole year. When you also consider the value of that gold, it’s about US$40 billion in six months into ETFs. The previous entire year was around US$22 billion, so the numbers are running at four times the previous record.

What does that tell us? The old school gold investor that is worried about fiat currency devaluation wants money out of the financial system. They don't buy ETFs, they buy physical gold. The gold ETF flows represent a huge number of new entrants into the gold market that want the price and defensive exposure in their portfolio. In our listed product, PMGOLD, over the last 18 months, the number of investors on the registry has quintupled, including a lot of small holdings. I think the QE and now MMT story are part of the move to gold but it’s highly nuanced, especially when billions of government bond yields are negative. What are the safe havens when equity markets are expensive?

GH: When you said earlier that institutions tend to go ‘direct’, does that mean physical gold?

JE: Correct. Physical gold which they store with a custodian like The Perth Mint depository. In the last six to 12 months, we saw a lot more inquiries from regulated entities such as large super funds, and also family offices. It’s more cost efficient to go direct in large quantities. They only have one counterparty to deal with whereas an ETF will typically have four or more counterparties (the product issuer, the trustee, the gold custodian and the market makers). And they get legal title to the gold. With an ETF, you don't own the actual gold, you own a security that is backed by gold. With physical gold, it has a serial number that is assigned to the investor. Gold ETFs are popular because they've made gold more cost effective for retail investors.

GH: So if a large institutional puts $200 million into physical gold, do the gold bars sit in a vault in Perth with unique numbers on them that the buyer can inspect?

JE: Yes, we have the largest vaulting facilities in the southern hemisphere and after 120 years in business, we store about $7 billion worth of gold for clients ranging from central banks to sovereign wealth funds to mum and dad investors. Yes, absolutely, legal title to their own physical gold in a government-guaranteed vault. And yes, the investor can inspect the physical gold directly.

GH: Why is it government guaranteed?

JE: Perth Mint is owned by the Western Australian Government and it stands behind the liabilities that we have to depositors. Any investor in a Perth Mint product is protected by that.

GH: And what about SMSF demand?

JE: There's been incredible flows the last 12 to 18 months. COVID accelerated a trend that was already in place. It really started in Q4 2018 which saw a huge decline in equity markets on talk of Fed tightening and gold started to take off. Our ETF has quadrupled in size in the last two years.

GH: Last question. What could cause a bear market for gold?

JE: If the US dollar were to rise significantly, or if real interest rates were to rise, that might put downward pressure on gold. It would increase the opportunity cost of holding gold if investors could get 5% on US Treasuries and inflation stayed at 1%. And if we had genuine, rip-roaring bull market in equities due to corporate earnings and not just central bank liquidity, money might move out of gold.

Those are three factors that could drive gold lower. In reality, I expect low real yields for years to come, and equities are not cheap. The rationale behind investors wanting to own a hedge such as gold remains strong.

Jordan Eliseo is Senior Investments Manager at The Perth Mint, a sponsor of Firstlinks. This article is general information and does not consider the circumstances of any investor.

Thomas Rice on new technologies with more potential to grow

23 September 2020

Thomas Rice is Portfolio Manager for the Perpetual Global Innovation Share Fund, a long-only global fund focused on investing in new trends in innovation and technology. This article first appeared under the title, 'Interview Series: What's new in a global innovation fund?'

GH: Managing an innovation fund must be the best job in funds management. What have been your big winners in the last year and why did you buy them?

TR: Yes, the Perpetual Global Innovation Share Fund returned 43% net in the year to end August so there have been many winners. We've held 31 different stocks that each added 0.5% or more. Three of the biggest were Zoom, Axon Enterprise and Vestas Wind Systems.

I'll start with Zoom, which the Fund first bought in April 2019, the day it listed. What struck me about the company was it was one of the fastest growing SaaS (Software as a Service) companies in the world while having positive margins which is incredibly rare. Most SaaS companies have negative margins because they spend so much on customer acquisition. Videoconferencing seemed like a mature market, but Zoom was winning significant market share for two reasons. First, an incredible focus on the customer experience made it easy to use, which was new at the time. And second, Zoom was built for the cloud, and technically, it was far more reliable than competitors with efficient switching and routing. Then in March 2020 as video conferencing grew during COVID-19, I invested further in Zoom, and it became the biggest position of the Fund at 6.5% at the time.

GH: What about the impact of COVID on other parts of your portfolio?

TR: In February, my focus honed in on the potential impacts of COVID on the portfolio when the virus moved beyond China. I sold out of travel company Expedia and Disney. But I also went on the offensive and Zoom looked like a major beneficiary. I increased it to 10% of the Fund as I gained more confidence in the stock. Zoom went from 10 million daily meeting participants in December to 200 million a month then 300 million.

GH: But didn't you then have a problem about the maximum proportion of the Fund which can be held in one stock?

TR: The Fund can hold up to 12% of one stock at the time of purchase or up to 15% with a market movement. We only hold that when I have a lot of confidence in the position. With Zoom, I talked to their existing customers and estimated how many the S&P500 companies had signed up by tracking subdomains. For example, a large customer like Nike will have a subdomain like nike.zoom.us. This allows you to check if those domain names exist and therefore, if they are Zoom customers.

GH: And you had strong confidence in another name?

TR: Yes, Axon Enterprise was the biggest contributor to the Fund in its first year in 2018. When I found this company in 2017, their main focus was Tasers, but they were also investing heavily in body cameras. I had previously done a lot of work on AI and machine learning, and I knew technology was improving and that they could interpret videos and images better than ever before. I also knew that transparency in policing was becoming important and I thought police body cameras would become the norm.

These body cameras are not like a GoPro camera, as some people assume. It's more of a data management business. It's not about selling devices, it's selling a monthly plan where a police officer puts the camera on a dock which uploads the evidence into a cloud platform on evidence.com. It's a subscription software business managed where they can tack on AI processing to add value. Axon's service allows tracking of police officers in the field and livestreaming of videos in real time, at say, high-profile events.

Body cameras are already used in Queensland and Victoria, and internationally they recently won their first contract in India. Axon cameras are also expanding into new areas, such as forestry services, border patrols and prisons. In fact, Corrective Services NSW deployed 336 body cameras in December. I view Axon as a perfect blend of understanding the technology plus knowing the space they operate in. The Founder and CEO is doing his life's work running this business. He wrote a book called 'The End of Killing' where he talks about his mission to make the bullet obsolete.

Axon's focus on AI includes an AI Ethics Committee with independent third parties. They've committed to not using face recognition in any of their cameras because they don't believe the technology provides a fair outcome.

GH: How has the share price performed?

TR: The Fund first invested in Axon in June 2017 at $24 and it's now $84 and a large part of the portfolio. Just think how often you now see body camera footage in the news.

GH: And your third best stock?

TR: That's Vestas Wind Systems, a renewables company. I became interested in wind power when the cost of energy for onshore wind power dropped below fossil fuels in many parts of the world. Vestas Wind Systems is the largest onshore wind turbine manufacturer in a business where scale matters. I think that wind will become an increasingly important part of the energy mix.

GH: We know that many tech and innovation companies trade on extremely high PEs or make a loss. How do you value a company that makes a loss?

TR: In my career, I've bought value stocks and yield stocks and growth stocks and bonds, and I personally invest in startups. And I don't think about them very differently. I go back to first principles, the present value and future cash flows. As long as you understand the underlying assumptions, it's about what the business will earn over time. For a mature company, the near-term earnings are a better proxy for earnings, but for a growing company, you might need to decide how the business will generate a profit in 10 years' time.

For example, what is the value of a company adding customers and how are they monetising it? Take the example of Facebook, where early on, they weren't showing many ads, but they have increased that overtime and monetised their asset. You need a good understanding of costs. How do the costs change over time, are there scale benefits? Put all those pieces together into how you believe the economics will transform in the next five to 10 years. Then you can get a sense of valuation.

I also like to invert the question. Based on where the stock is trading today, what would have to happen to justify the price here? That's often better than a point estimate of valuation which can give you a false sense of security.

GH: Is there an example of a company that the market loves, and you don't.

TR: It's hard to say the market is clearly wrong at any time, but I feel with companies like Uber or Tesla, much of the valuation is based on something that may or may not happen, such as the rolling out of an autonomous car network. I can imagine scenarios where that will happen, but I wouldn't want to bet on that outcome. I want more confidence that something beneficial will happen.

GH: So, the good outcome is already in the price. How do you feel about the big techs, the Facebooks, Apples and Googles?

TR: Apple has clearly gone from being seen as a hardware company to a services company. It's rerated from 15 times to 33 times earnings, but I think it's fully priced now. Facebook still offers reasonable value. I don't think Google, Amazon or Microsoft are too expensive.

GH: Among these many successes, what has been a poor stock for the fund?

TR: Vivendi. It's a conglomerate and their biggest asset is the Universal Music Group. I like this due to the rapid growth of music streaming where content is dominated by only three players: Universal, Sony Music and Warner Music. But other assets in the conglomerate aren't as attractive and the share price has not done so well.

GH: To manage an innovation fund, do you need to be an optimist, even a dreamer, with a lot of faith in the future?

TR: No, not an optimist, more a realist. You need to see the truth in how the world is changing and invest according to that, rather than hoping for the best.

GH: Is there an innovation the market has not recognised enough?

TR: I still think the market is underestimating the shift to renewables. We have reached a tipping point on cost comparisons versus conventional energy. Every year that passes, renewable costs will decline, especially with improvements in batteries and solar.

GH: What has been the biggest miss or act of omission in your portfolio?

TR: My biggest miss has been Apple and the way they have built a services business. Also, Shopify has done incredibly well as an alternative infrastructure provider in the way it competes with Amazon. COVID has been a real accelerant for e-commerce generally. It's a company that I've watched closely but always wanted it a bit cheaper.

GH: Do you own any Australian stocks?

TR: We own Nitro Software, a PDF software company that's also into e-signatures, which I think the market has undervalued. With COVID, you need to understand how behaviours are changing, including the digitisation of office documents. But I tend to focus outside Australia while staying close to the Perpetual Australian Equities team here.

GH: Would you like to see a market pullback to buy into some stocks at better levels?

TR: Not really, I love how the portfolio is positioned, we own a lot of great stocks where we have bought in at cheap prices. The Fund is underweight in the US and I'd like to own some big tech stocks at cheaper prices, say down 10% to 20% from here. But for me, it's more about what are the best companies in the world today based on where prices are now.

This is the way I frame it - there are 10,000 stocks in the world that are liquid with a market cap of over $1 billion. You should always be able to find something that's good value for a portfolio of around 40 stocks. You will never hear me say I can't find anything worth buying.

GH: What about e-sports and the gaming industries?

TR: Gaming has always been a part of the portfolio and the quality of games is now amazing. It's a growing segment of the entertainment industry with excellent ongoing demographic shifts. And it's also an area that a lot of fund managers tend to ignore which I find very surprising. I've always had 10% or so of the portfolio in video games. The ubiquity of mobile devices that can be used for gaming has been a huge driver as well. One way to get exposure to that is Unity Software, which is a game engine company that powers 53% of the top 1,000 mobile games. They just listed last Friday.

GH: Before we close, we should address the shadow that hangs over companies such as Facebook and Google, and that's the threat of regulation. This extends to AI where people are concerned about privacy. How do you factor that in?

TR: Yes, it's an important question and one that has a way to play out. There have been a number of instances where companies like Facebook have been too slow to understand their social license to operate. Data is a good example of that. There are huge benefits in using data to better understand your clients' needs but at what point does that use of data actually become unethical or a breach of privacy? In the absence of self-regulation, there will ultimately be a regulatory response. The more recent issue of spreading misinformation is complex and addressing it will be difficult and costly as companies build the systems to better manage it.

Perpetual is a sponsor of Firstlinks and more details on the Global Innovation Share Fund can be found here. This article is general information and does not consider the circumstances of any investor.

Claudia Huntington's lessons from five decades of investing

30 September 2020

Claudia Huntington is an Equity Portfolio Manager at Capital Group with 47 years of funds management experience. She began her investing career in 1973 — a period of rapidly rising inflation and volatile markets — and has decided to retire in 2020. She recently sat down to share insights and lessons learned over nearly half a century as a professional investor.

Our best investment decisions are made when we are on the same wavelength as the CEO. We gain a deeper understanding of their talents and the likelihood that they can successfully navigate risks and execute their strategy. Quarterly results are important, but taking a longer view can lead to a rich dialogue with company leaders.

What are the most important lessons you've learned?

I've learned that this business is more art than science. Early in my career I thought it was primarily about math and perfecting my model. Sure, you need math, but the more you invest, the more you realise it's about making judgments — about people and about the future. There are no facts about the future, so you have to try to look around corners.

Perhaps the most important lesson I've learned is that a company's management is essential to its ultimate success or failure. If you have a great company run by a poor CEO, the odds of that company turning into a good investment are low. On the other hand, if you have a mediocre company in a mediocre industry with a superb CEO, then it is much more likely that company will turn out to be a good investment. So, being able to calibrate CEOs and management teams is an important skill to develop.

Who are examples of CEOs you've encountered who were difference makers?

A recent example is Satya Nadella, Microsoft's Chief Executive. He was not an obvious choice to run the company when he succeeded Steve Ballmer in 2014, but he has excelled for a number of reasons. One thing Satya does at the end of every meeting, regardless of whom he is meeting with, is ask, "What do you think?" The fact that he wants to encourage participation, to hear other voices, is such a demonstrable, cultural advantage.

One of the most effective CEOs I've ever encountered was Mark Donegan of Precision Castparts, a maker of specialty metals for the aerospace and defense industries. Donegan is a detail-oriented leader with a laser focus on productivity and a great allocator of capital. But what is most special about Donegan is the culture he has fostered at his company. He created a real sense among his employees of working together to do the right thing.

I often ask executives to describe the culture of their company. Some have great answers; others look at you like you came from the moon. The best companies are often the ones with a very strong culture.

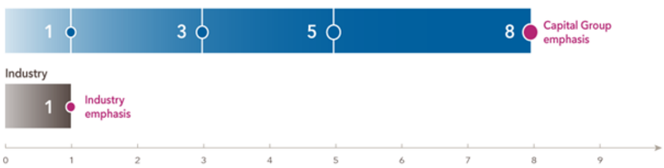
Identifying a strong CEO is no guarantee of long-term investment success. Years ago, I invested in a company called Silicon Graphics largely because I believed the CEO was first-rate, and I had faith in his strategy for the company — a maker of specialized computer systems for graphic applications. We identified the opportunity early, and the company experienced strong growth. The investment was a good one — until it wasn't.

The CEO eventually got interested in politics and essentially assigned running the company to a subordinate who made a series of bad decisions. I had established such trust and faith in the CEO that I didn't look more closely when changes were made. That was an important lesson for me.

How has culture shaped you as a portfolio manager?

At Capital, we are encouraged to focus on long-term results. In fact, under The Capital System^{SM}, compensation paid to our investment professionals is heavily influenced by results over one-, three-, five- and eight-year periods. Increasing weight is placed on each successive measurement period to encourage a long-term investment approach. Our culture is also designed to encourage what I call the lonely idea. By definition, good investments are not something everyone knows about. It takes a great deal of courage to identify an opportunity early on that has the potential to be a great investment.

Long-term focus is built into The Capital System^{SM}
Portfolio manager compensation basis (years)



Source: Capital Group. Compensation paid to our investment professionals is heavily influenced by results over one-, three-, five- and eight-year periods. Increasing weight is placed on each successive measurement period to encourage a long-term investment approach.

Precision Castparts, the company I mentioned earlier, is an example of a 'lonely idea'. On paper this company was not that interesting. It was in the industrials space, with a concentrated number of clients and limited supply sources, so there were risks. When I travelled to Portland to meet with CEO Mark Donegan, I found the headquarters on the third floor of a small unmarked industrial building next to a gravel parking lot down a dirt road. Clearly this was a cost-conscious company. I found it to be to be well-managed and operationally focused.

When I presented this unlikely investment idea to our investment group, I was challenged by my colleagues. They were polite and respectful, but skeptical. "Why would you want to invest in a specialty metals company in this stage of the cycle?" But the beauty of The Capital System, is that I could act on my conviction to invest, and by doing so I convinced some colleagues to invest with me. Our system allows that bright spark of the lonely idea to shine through rather than being dimmed by consensus.

You have seen your share of downturns. What advice do you give younger colleagues?

I started my investing career near the beginning of one of the worst bear markets since World War II. My first job was at another asset manager that had three rounds of layoffs in my first six months. Capital ended up acquiring the firm's assets, which is how I came here. This early experience taught me that this is a very volatile business but that down markets are opportunities.

We try to reassure associates during periods of uncertainty and encourage them to focus on long-term opportunities that may arise. With the COVID-19 pandemic leading to a recession and bouts of volatility earlier this year, I shared with younger colleagues a list of 10 tips for weathering market downturns to provide some perspective from my own experiences. Among them are "don't dwell on what the market did yesterday," "pay attention to balance sheets," and "keep talking to companies." The easiest thing to do in a downturn is to just freeze, so many of my suggestions try to help colleagues manage emotions and take action.

10 tips for weathering market downturns

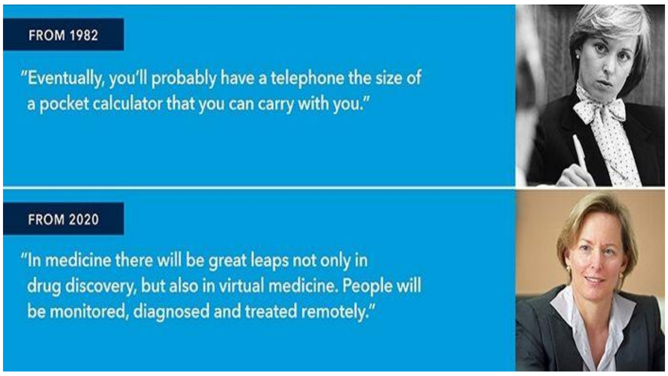
- Do scenario analysis
- Pay attention to balance sheets
- Keep talking to companies, but understand they don't know more than we do
- Don't dwell on what the market did yesterday
- Try really hard to see around corners
- Keep Will and Ariel Durant's "The Lessons of History" handy
- Remember buying opportunities may exist when fear is at its worst
- Keep a current wish/worry list and update it daily
- Humor helps, so talk to one another
- When things are bleakest, think about what "green shoots" could make the future "less bad"

For a primarily U.S.-focused investor, you have spent much of your time traveling abroad. Why is that important?

First and foremost, traveling gives me fresh perspective on the companies that I follow. So many companies today have global operations and customer bases. I can travel to India, for example, and visit a pharmaceutical business. That's going to give me perspective on all pharmaceuticals, wherever they are.

I travel to get some notion of the competitive environment, but also a sense of where challenges could come from or new opportunities. To truly understand a company — or a market or an industry, for that matter — you really have to go see it with your own eyes. You can't do this job from a Bloomberg terminal.

Claudia Huntington's predictions for the future



As an investment analyst in 1982, you predicted the coming of the mobile phone. How do you think the world will be different in 10 years?

I have witnessed remarkable change in my career, not only in terms of investing opportunities but also global opportunities.

When I started, there were no cell phones, no internet, not even desktop computers. I am certain there will be comparably huge leaps in the coming years. Many will be in technology, but there will be leaps in other areas. With respect to energy, I expect there will be some fabulous storage technology and better battery technology. That's going to have a tremendous impact on the kind of transportation people use. There will be major changes in agriculture, in the way farms operate.

I think one of the most exciting areas is medicine, where I believe there will be great leaps not only in drug discovery, but also in virtual medicine. People will be monitored, diagnosed and treated remotely.

What drew you to a career in investing?

I would describe myself as someone who has always been interested in learning about the way things work. That's what drew me to study economics in college and then to a career in investing.

Capital has a culture that encourages lifelong learning, which really has been a perfect fit for me. I am working on a project to quantify the role that management plays in a company's stock returns. I'll be working on it until my last day in the office!

Claudia Huntington is an Equity Portfolio Manager at Capital Group, a sponsor of Firstlinks. Claudia has 47 years of investment experience. She holds an MBA from Harvard and an Economics degree from Stanford.

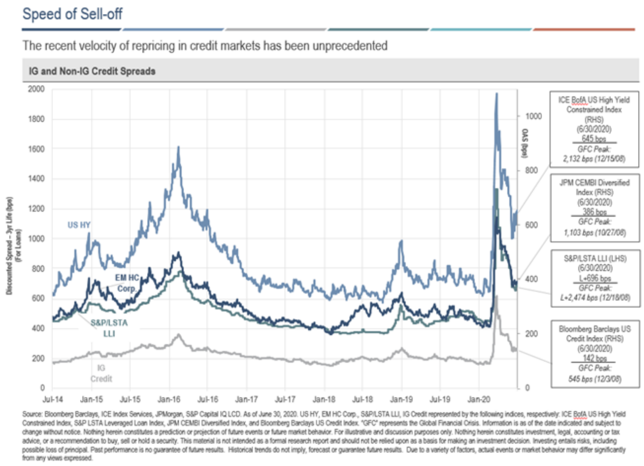
Vivek Bommi on how markets saved companies with zero revenues

7 October 2020

Vivek Bommi is Senior Portfolio Manager and Managing Director at Neuberger Berman in London. His responsibilities include management of the Listed Investment Trust, NB Global Corporate Income Trust (ASX:NBI).

GH: A lot has happened in the corporate bond market since March. The Bloomberg High Yield Index on 23 March was 11.69% and now it's about 6% which is an extraordinary recovery. How do you summarise the last six months?

VB: At the market low, the world was struggling to understand what lockdowns meant, and the virus was looking bad in China with potential to hit the world. Markets were shocked that people were suddenly working from home. People were worried about public health, and investors in risky assets were trying to sell because the unknown is the worst thing for risky assets.



At the same time, in late March in all fixed income markets not just high yield, there was a big liquidity mismatch. Lots of sellers and no real buyers as the natural buyers were either fully invested or assessing what was in their portfolio. We went through each name to see what the effect of a zero-revenue environment would be on each company and whether we needed to take action.

GH: What's an example of a bond that was sold off but represented good value?

VB: Well, there was a one-year bond from Caterpillar, a US-based investment grade company, and because someone was trying to sell it, the bond sold for below 90. That's a 10%-plus yield on an A-rated company. It was not a high yield problem, it was everything, even off-the-run Treasuries.

GH: Then what happened?

VB: First, the Fed stepped in and said it would buy investment grade issuers by expanding its balance sheet, and that calmed markets as people stopped worrying about investment grade names rolling over their debt. Second, and more subtly, the Fed backstopped fixed income ETFs. At that stage, fixed income ETFs were trading at a discount and big selling then feeds upon itself. And third, governments around the world stepped in with fiscal policies. Increasingly, markets looked well forward to understand the longer-term consequences.

All these combined to give a better sense of the impact coronavirus would have on various companies and broadly speaking, it was not as bad as first feared. And so capital markets reopened quickly. Companies which needed cash could access equity markets or debt markets. Of course, certain industries were more impacted, such as theme parks and travel for example. But even they were able to raise capital to withstand multiple years instead of multiple months of zero revenue. It changed the dynamics and the picture on the number of defaults.

Notable Sectors & Themes

	2Q20 Earnings	Forward Outlook
COVID-19 Acute Leisure, Lodging, Entertainment, Gaming, Airlines, Retail	• Near zero revenue environment • Cost rationalization, minimization of cash burn and ability to raise liquidity better than market expectation	• Consumer demand for leisure activities has surprised to the upside following re-opening, sustainability of trends is uncertain • Issuers believe some level of cost/margin performance is sustainable • Airline ticket demand has flattened
Cyclicals Autos, Chemicals, Metals, Industrials, Homebuilding	• Wide range of outcomes • Ability to match cost structure to revenue key driver of results – in general, issuers have outperformed expectations on cost side • Working capital was a material tailwind during the quarter • Homebuilding and building products notable relative outperformers	• Issuers seeing sequential monthly improvement in demand/revenue through June/July. Rate of improvement has moderated in July • Strong homebuilding demand continues • Working capital likely a use of cash in 2H20 (assuming trends continue)
TMT Telecom, Cable, Broadcast, Media, Technology	• Limited impact on telecom/cable earnings • Limited impact on software earnings • Technology performing relative well (but with mixed end markets) • Ad-dependent media revenue down 30 to 50%	• Broader TMT outlook generally consistent with 2Q earnings • Limited visibility on ad-dependent media revenue
Healthcare	• Hospital revenue down 10 to 25% • Working capital benefit with federal grants and Medicare advance payments • Labor and cost adjustments helped mitigate volume declines • CROs, suppliers, managed care have been net beneficiaries	• Volumes improved towards QE at ~85-90% of pre-COVID • Potential for additional government support for hospitals/providers • Lagging ER volumes (impact on physician services names)
Energy Energy, Gas Distribution, Utilities	• Issuers reporting earnings in-line with low expectations driven by significant YoY decline in commodity prices • Midstream business model impacted but more resilient than upstream • Utilities performing relatively well, particularly retail operations	• At current commodity prices issuers are re-starting shut-in production and beginning to complete already drilled wells • Near-term drilling activity is expected to remain at depressed levels • Issuers focused on managing production declines while minimizing capex
Financials	• Loan demand weak in 2Q but improved throughout quarter, stability in June/July • Balance sheet metrics stable to improved sequentially and YoY • Provision trends mixed but generally better than expected	• Deferral requests have declined significantly since March/April • Repayment trends have been in-line with expectations • Credit losses expected to be ~stable, FY21 still uncertain (stimulus, recovery)

This material is intended as a broad overview of the Portfolio Manager's views and is subject to change without notice. Portfolio Manager's views may differ from that of other portfolio managers as well as the views of the firm. Nothing herein constitutes a prediction or projection of future events or future market behavior. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed.

GH: Was the Fed activity in ETFs and direct bonds confined to investment grade?

VB: No, they also bought high yield ETFs as well. In bonds, they specifically picked names that were downgraded from investment grade to high yield. But in fact, they did not do that much, but just having that backstop gave people a lot more comfort.

Now, at this point, when you look at fixed income, high yield credit is one of the few games in town. It's a large, diverse market of US$2.5 trillion, including regular companies everyone knows, which makes them easier to analyse. Not much else offers yield anymore, neither governments nor investment grade unless you're willing to go out very long in the curve. Some money is going into emerging market sovereigns, but many people are less comfortable with that.

In the last few months, there's been US$30 billion of retail flows into high yield funds and another US$30 billion of institutional money so the market has a good tailwind.

GH: Are you concerned about the 'zombie' companies which could not refinance their debts if not for this injection of liquidity? Is the can kicked down the road?

VB: Realistically, few companies pay off all their debt anyway and it's an efficient use of a balance sheet to run with some debt. If a person takes a 30-year mortgage, over what time frame do they expect to pay it off? Almost every company can pay off all their debt in 30 years because corporates are long-term entities. Individuals want to pay off 100% of their debt because they stop working, so it makes sense.

Now, there are certain industries that have increased their debt load and are burning cash, and they probably have more debt sheet than is preferred. They need to pare it down, the obvious examples are hotel companies, leisure cruise lines and the like. Some of these have moved from investment grade companies to high yield. Over time, as their earnings and stock prices improve and they start repaying the debt, they'll probably move back up but it'll take a while.

GH: Do some companies borrow even if they don't need the money immediately?

VB: Frankly, some take out debt as an insurance policy. Those companies have other debt maturing within 12 to 24 months out and they're sitting on cash and will probably repay their debt. Ford is a perfect example. Pre 2005, it was an investment grade company, it took out a lot of debt for its restructuring and then earnings had a problem. It was downgraded to high yield in 2005 but by 2011 it was back to investment grade. I characterise a zombie as a truly insolvent company, meaning its debt load is in excess of its enterprise value. Those don't last long because markets are pretty efficient. Banks and bond markets won't lend to them.

GH: What about governments? Australia now has over a trillion dollars of debt, are we passing problems to future generations or don't we need to worry because the debt doesn't need to be repaid? It can just be rolled over forever when it's a government.

VB: Yes, but as you increase your debt, whether a corporate or a government or an individual, you are creating less flexibility in the future. There's a natural limit to how high you can go. At least corporates have levers to pull in cutting costs or raising equity to generate cash flow. Some corporates prefer to raise equity than debt to maintain financial flexibility in the long term.

GH: Your highest-profile fund in Australia is the listed trust, NBI, and it's been part of this high yield journey in 2020. What has Neuberger Berman done in the last six months to address the falling share price and the discount to Net Tangible Assets (NTA)? It's seen a strong recovery and now the discount is narrow.

VB: The market has obviously improved from the lows, but we have been engaging with our clients as much as possible, explaining the story. The goal is to pay out a Target Distribution on a monthly basis which we have been doing. We have full transparency in the portfolio, which shows large companies rated by the three major rating agencies. Some of our peers say their portfolios are investment grade and in the fine print, the rating is done in-house, not by independent agencies.

GH: In Australia, the big flows into ETFs have been in global equities but also very strong into fixed interest in various forms. And yet, investment grade returns are very low in a fragile economy. How are investors justifying such large fixed interest flows with returns that barely cover inflation?

VB: First is protecting their portfolios from another equity drop, especially after the market rally. Second, if you take a look at the main corporate bond index (the ICE BofA US Corporate Constrained Index with a market value of US$8.3 trillion), the year-to-date return is 6.7%, which sounds good, but the current yield is only 2% because it includes US Treasuries. Investors don't look forward, they say, "Wow, investment grade paid nearly 7%, I should put money into that." But US Treasuries returned 11%, meaning the rest lost 4%. With a yield of 2%, if you're just a little wrong on rates, that wipes out your total return.

GH: So the gain is all in the duration and not the credit. The last time I saw the duration of the index, it was out to about seven years, so a 1% rise in rates means a 7% loss of capital.

VB: It's now out to 8.2 years. It's the largest investment grade index. Yield of 2%, duration over 8 years. If rates go up only 0.25%, you've pretty much zapped all of your yield right there.

In Australia, many retail investors have their money in bank hybrids as their fixed income proxy, which has worked. Yet they have a much higher aversion to non-investment grade debt than almost anywhere else in the world. They think if a company is rated 'junk' it's a terrible company because junk means bad. But the median EBITDA of companies in our portfolio is about US$1 billion. The median EBITDA of the ASX100 excluding banks is less than A$200 million. These high yielders are not small companies.

GH: What is NB doing in the investment grade space that is available to Australian investors?

VB: We offer a flexible multi-sector global bond solution, the Neuberger Berman Strategic Income Fund, which has an investment grade average rating. It's also has a monthly distribution which we think appeals to those looking for a good durable income steam.

GH: Let's finish up with your market outlook.

VB: If the US election has any impact, it will impact more on broader markets and you may see some of that translate into mark to market within high yield. But we don't see a major impact on the credits in our portfolio. Biden will probably increase scrutiny on big tech but that affects little in the mainstream economy.

There is a possibility that the Democrats may spend more which might put some upward pressure on rates.

On the virus side, I live in London and there is no real lockdown. It's not like March and April where you couldn't go to work and only grocery stores were open and you couldn't travel outside of London in your car. That was a real lockdown. I'm usually asleep by 10 o'clock so the new curfew on bars and restaurants has no impact on me.

The capital markets have been functioning well, supported by the US Fed and central governments, the future volatility in fixed income should be significantly lower even if we go a second lockdown.

Both the virus and the election are highly consequential for the long term. We are keeping risk levels in check given their volatile nature and the range of potential outcomes.

GH: The high yield market has improved a lot since March. Is there still value there?

VB: I think there's still good value. In today's global index, the yield is about 6% with 3.8 years of duration. So if rates move, say, 1% up, there's enough yield to compensate for that. But rates will only move up if there is growth in the economy, which is good for credit. We now know far more about the likely impacts of the virus on most companies.

Vivek Bommi is a Senior Portfolio Manager at [Neuberger Berman](), a sponsor of Firstlinks. This material is provided for information purposes only and nothing herein constitutes investment, legal, accounting or tax advice, or a recommendation to buy, sell or hold a security. It does not consider the circumstances of any investor.

Hamish Douglass on what really matters

21 October 2020

On 13 October 2020, Hamish Douglass (Co-Founder, Chairman and Chief Investment Officer of Magellan Asset Management) held a webinar with Frank Casarotti (General Manager, Distribution at Magellan) called 'What Really Matters'. The questions were submitted by attendees and these are edited highlights.

FC: Why is there such a disconnect between the world economy and the share market?

HD: I often get this question. You have to remember that sharemarkets forecast the future. They are trying to discount all the cash flows of a business from now to Judgement Day to figure out what it's worth. It's factoring in what's happening in the next 12 months but also the next two years and five years and 20 years into the future. When you look at the economy, it's really a very static picture. It's telling you what's happening today. We could have unemployment or credit losses but that's not telling you what the unemployment rates will be in five years into the future.

So you often get this disconnect. You ask yourself at any point in time whether the market is being irrational. There's so much uncertainty at the moment but the market has had a very strong rally, close to its all-time high. Is that completely irrational? It's reflecting a number of things, such as very low interest rates, and the lower interest rates are, the higher company valuations can be because the discounted future cash flows are higher in a low interest rate environment. We've seen an incredible amount of fiscal stimulus and monetary support, and there's a view in markets that with all these trials, a vaccine will be found in 2021.

FC: On the holdings in your portfolio, how comfortable are you on the valuations?

HD: Well, we wouldn't be holding things if we weren't comfortable with valuations. We sold Apple recently because we think it went past our assessment of fair value. Obviously, the market disagrees with us, but we think we're disciplined on valuation. It reflects our view on where interest rates are heading which justifies higher valuations than may have been the case five years ago, although some stocks are more fully valued than others.

FC: What's your most profound observation on the markets over the last 12 months?

HD: I don't think I have many profound observations, but you should never be surprised by what actually happens, or how markets react. You should expect the unexpected. Events like this virus have happened in the past and they're going to happen in the future, although the scale of the economic damage was unexpected. I don't think any of us envisaged the willingness of governments to spend 10 to 20% of annual economic output to manage the downturn. There's almost been an income surplus from the fiscal expenditure. But we want to build resilient portfolios for long-term investors and expect the unexpected.

FC: Does the rising debt matter if interest rates remain low for a lot longer?

HD: It looks like governments don't think that it matters, but taken to extreme, of course it matters. Our own government that was so opposed to debt and deficits is taking on extraordinary amounts of debt. And the argument is, there's no interest cost for this because interest rates are so low. It's almost free. But if we take this to the extreme, why don't we just get rid of all taxation, and governments just borrow the money. Of course, that isn't sustainable.

This even has a name, Modern Monetary Theory. There will be a day of reckoning. Just because interest rates are super low today, you cannot assume they will always be low. And if you believe debt is free and debt has no consequences, you might as well believe in the tooth fairy. One day inflation will come back and one day interest rates will have to increase.

But this period could last for a very long period of time. And what worries me is the longer this goes on, more and more politicians may start believing in the tooth fairy because they have relatively short election cycles. What are the restraints on them to spend the money today and believe it's a free lunch? I hope there are some rational voices at the table. I think it's been prudent for governments to be aggressive in their in their response in the last six months, but future generations will have a lot to bear. I hope this trend does not get too much momentum.

FC: What are the consequences of this lower interest rate and lower growth environment?

HD: Income and profitability and equity returns will grow more slowly in aggregate and that's going to be a very difficult environment for investors to navigate. They can't simply put their money in the bank, which means they need to be very selective to find reliable growth.

FC: What's your medium-term outlook for the FANGs versus the BATs (Baidu, Alibaba and Tencent).

HD: It's an interesting way to frame the question but I don't regard this as one versus the other. They are subject to different risks. Many of these platforms are highly advantaged businesses and most (except Baidu) have the most powerful business models we've literally seen in the last 100 years. You probably need to go back to the railroad barons 100 years ago. There are very strong network effects in place and they're light in terms of the capital usage, outside of Amazon. I call this 'capitalism without capital', it is truly extraordinary. The FANGS are global plays, ex-China, with ecommerce, digital advertising, cloud computing and entertainment. The big Chinese tech platforms are even broader than the FANGS, including gaming, videos and music. They're into payments, financial disintermediation and local services like delivery.

But all these companies will attract the attention of regulators, so the real questions are, what are the risks? And what are they worth? Yes, we want to buy them when we think they're priced at less than we think they're worth, taking the risks into account. All of them are extraordinary in their own ways.

FC: Does Magellan's long-term thesis of 9% returns still hold despite the pandemic?

HD: This is a really good question. Overall market returns have been good in the last decade or two because of falling interest rates. As Warren Buffett says, interest rates are the gravity of markets. World profitability is probably not going to grow at 9% per annum and we are probably in a low growth world for the next decade. So equity returns in aggregate will be materially below 9% per annum. But we're running a concentrated portfolio with unique sources of growth, and we're not going to lower the bar because it's harder. There's no guarantees that we will achieve 9%, and we will be judged over a full investment cycle of seven years.

FC: Where do self-funded retirees find income when interest rates are so low?

HD: It's a tough one. We are planning to release a product that will answer part of this question, but people will have to take equity risk. So we're trying to mitigate that risk in the product. But I don't have a single solution. I'd be careful about just reaching for income and going down the risk spectrum.

FC: Do you have any advice for younger advisers who are fairly new to the industry and navigating this pandemic early in their careers?

HD: Well, expect the unexpected. If you're an adviser or an investor, stay the course, investing is a long-term business, not determined over three to six months. Find the right businesses and the investments that can compound returns over a long period of time. If you find good businesses, you can largely ignore the short-term issues such as in the last six months. I know it doesn't seem exciting for people who want to trade in and out, but great wealth is built out of compounding.

My best advice is to understand the power of compound interest. As a young person, you have a major advantage over the vast majority of people on this call. You have the advantage of age, and time is super valuable. In this game, as Benjamin Franklin famously said, money makes money, and the money that money makes, makes more money. And that's what investing is all about.

Hamish Douglass is Co-Founder, Chairman and Chief Investment Officer of Magellan Asset Management, a sponsor of Firstlinks. This article is for general information only and does not consider the circumstances of any investor.

The full webinar can be viewed here.

Kate Howitt: investing lessons and avoiding the PIPO trade

21 October 2020

Kate Howitt is Portfolio Manager for the Fidelity Australian Opportunities Fund which she has managed since its inception in 2012. She was included in CNBC's list of the world's top 20 female portfolio managers across equities and bonds and named in Citywire's top 30 female fund managers, ranking 11th out of 1,762 female active managers. She was with Fidelity when it opened its Australian office in 2004.

GH: Do you feel the economic stimulus packages in Australia have done enough to carry the market through to whenever a vaccine arrives?

KH: We have the benefit of good economic management in the past, which means we went into this with a clean sovereign balance sheet and a close-to-balanced budget. It gave us more room to maneuver than a lot of other countries. The Government has grasped the enormity of the challenge and thrown dogma out the window quickly with some effective policy responses. Globally, we've seen enormous liquidity injections and strong fiscal measures and now pump priming, but it wouldn't be surprising to see some wobbly patches as we move from one stimulus level to another, and not all jobs and businesses will survive.

GH: And allowing companies to continue trading while they are insolvent has delayed an inevitable wave of company liquidations which will hit the news in coming months.

KH: Absolutely, a reality check. And one of the challenges is to avoid creating a class of zombie companies. There needs to a constant creative destruction or winnowing out of weaker companies to leave sunshine for stronger companies to thrive.

GH: Your Australian Opportunities Fund invests across the market including small to mid-cap stocks. Do you feel the stock market has missed a sector or companies that you've identified?

KH: We've seen many COVID winners and losers. Some companies have benefited from people working from home but we're seeing a line of sight back to normalisation. We think there's upside in homebuilding in Australia, such as Bluescope (ASX:BLS) with Colorbond, but also a recovery of industrial activity in the US, particularly the auto sector. In smaller companies, we like the Australian biotech Starpharma (ASX:SPL). It has a range of therapeutic molecules, mostly targeted at the oncology space, but they've got an antiviral that shows great promise with regulatory approval already in major markets. Until a vaccine is thoroughly worked through and even beyond that, there will be gaps and a desire for a simple, low intervention nasal spray as a convenient therapeutic. And when you look at the market value of Starpharma relative to other companies around the world that have COVID-19 therapeutics, it's not being priced in at all.

GH: Where are you in the 'value versus growth' debate?

KH: Well, broadly, there are two ways to make money with stocks. One is to find stocks that are cheap now relative to the value today, and the other is to own stocks that are long-term winners. They may be fairly valued today but they will continue to grow through time.

Both are valid ways to make money but the latter that has really outperformed this year. Software companies and online retailers started expensive and then got much more expensive. That can be characterised as 'value versus growth' and growth has delivered for many years now. It's one of the big questions for markets: when will it make sense to buy those cheap companies with attractive valuations when such investing has not paid off for a while?

GH: So that leads to whether you see specific stocks and sectors the market is too optimistic about.

KH: There's a huge amount of optimism baked into the Buy Now Pay Later space and into the retailers and they've been clear beneficiaries of the lockdown. But it's hard to untangle how much of that is a structural shift caused by COVID versus how much is a short-term boost. When conditions normalise, will they lose some of those gains? There's not much margin of safety in those valuations.

GH: Where stocks run on their own price rise success and they lose connection with the fundamentals.

KH: Yes. The fascinating phenomenon is the shift in market participants. A couple of decades ago, markets were comprised of institutions and mum and dad investors. Both were working on price versus value. So whether a professional or not, investors would buy a stock based on a view of what it was worth, and its value over some time horizon. And that was pretty foundational.

But now the majority of investments are index flows or ETF flows trading on some other proxy of outperformance. They are agnostic on valuation, they don't even ask the question on what is fair value of a stock. They just ask the question, what's its weight in the index. Or does it fit into my ETF parameters or does it tick some other quantitative box like momentum.

Markets used to work on the wisdom of crowds, which was a lot of non-correlated guesses of how many lollies are in the lolly jar. The old saying was that in the short term, the market is a voting machine but in the long term, it's a weighing machine. Now, there's a lot voting activity and not nearly as much weighing.

GH: That's a great point, that we don't simply have a cyclical change but a new structure in the way the market works. Can anything break this pattern?

KH: It's one of the drivers of this extended bifurcation between growth and value. The things that do well draw even more buying support so inefficiencies and anomalies persist for longer than they would have in the past.

GH: What have been your best performers in 2020 and why do you remain keen on them?

KH: Our Top Three contributors over the past 12 months were Evolution Mining (ASX:EVN), Mineral Resources (ASX:MIN) and CSL (ASX:CSL). Evolution is our top pick in the gold space, based on both its own merits and the gold price. They've made a recent acquisition in Canada which shows a lot of potential on a medium- to long-term view. Management are good capital allocators in a sector where it's easy to destroy value by buying other gold companies when the gold price is high.

Mineral Resources has performed well, particularly with its exposure to the iron ore price. It also has lithium assets which the market has been attributing no value to. And CSL is a large stock but still capable of delivering strong growth although there might be some hiccups over the next 12 months from plasma collection.

In all three cases, quality management is a key part of investment thesis. We are believers in the Warren Buffett view on backing the horse not the jockey, so we are looking for companies that have strong competitive advantages. But where we can also get a good jockey, we like that a lot too.

GH: And at the other extreme, what is your biggest portfolio disappointment?

KH: Treasury Wine Estates (TWE). We had done well out of it for a while, but it's had a big tumble on the back of management changes and analyst views on its export markets. We like the business for the strength of its brands, notably Penfolds, and the management team has been reorienting the business towards cellaring for longer to make more luxury wines. The cost is keeping the inventory on the books for a couple of years, but we like that re investment. It will come through in earnings in future years.

GH: We have all read about the 'Robinhood' retail investors, particularly in the US, but do you see the same influences in the Australian market?

KH: We always had a strong retail component but it was mostly centered on fully franked dividend stocks, which made a lot of sense. But there is now a lot of trading in a new cohort of stocks, such as Afterpay (ASX:APT), Zip (ASX:Z1P) and Mesoblast (ASX:MSB). In the US in the 1960s, retail was about 40% of stock trading flows but it had fallen to 10% by 2010 and now it's back to about 20%.

One part of me says this is great, this is capitalism in action, the benefits of Wall Street being made more available to Main Street. But then part of me thinks that this is just people who are unable to engage in sports betting and going to the casinos and having a flutter, and they are bringing that mentality into the stock market. This type of activity does tend to be a hallmark of a late cycle. So I'm unsure whether to applaud this as grassroots capitalism or take it as a sign of a speculative top.

GH: And when you read social media posts on TikTok and Reddit and even Twitter, there's a lot of chat about how easy it is to make money in stocks. You've spoken before about TINA and YOLO. What will it take to shake these new participants from the market?

KH: So let's break down those acronyms. TINA is 'There Is No Alternative'. It's more an institutional phenomenon, that since the GFC and increasingly in 2020, monetary policy has made the largest securitised asset class in the world, ie the bond market, less attractive. Bonds now offer high volatility and low returns. So where else does money go but the next largest securitised asset class, stocks? I call these investors 'bond market refugees'. Their natural home is bonds but they can't stay there anymore. They can't move quickly back because if you've called the top of the bond market, it's the end of a 30+ year cycle. It's not something that plays out in a month or two. It may give strong support for equity markets globally for years. They are not buying stocks because they're cheap but because of the relatively-better prospects than bonds.

Contrast that with YOLO, which is 'You Only Live Once', which is a tag some retail punters put on their trades. If you're a YOLO day trader, you're not buying stocks because you've done your DCF valuation. You're buying because it's a thrill, to have something to do in an otherwise really boring lockdown.

So TINA has legs and can go on for longer whereas YOLO probably runs out either when people either exhaust their stimulus money or sports betting ramps back up or people go out and do more interesting things. I think it will fizzle out in a nearer term.

GH: What advice do you offer to less experienced investors?

KH: There's the predictable answer that they should find a quality active manager, as we have hundreds of analysts whose job it is to understand stocks and work really hard on a client's behalf. But for those people who enjoy investing for themselves, it's good to go through the mental exercise of asking if markets fell 30% from here, would I be a forced seller? If so, sell some now and put some cash on the sidelines. It's much better when markets fall to scoop up bargains rather than sitting there feeling terrible because you're a seller at knockdown prices. Position yourself to take advantage of volatility rather than being hurt by volatility. It's a foundational part of managing a portfolio.

GH: And we've all seen investors who sell after the market falls and buy after the market rises and end up with the worst result of buying high and selling low.

KH: Yes, my head trader at Fidelity constantly warns against the PIPO trade, which is 'Panic In, Panic Out'. People have evolved to PIPO and it's hard to resist and make well-reasoned investment decisions.

Kate Howitt is Portfolio Manager for the Fidelity Australian Opportunities Fund. Fidelity International is a sponsor of Firstlinks. This article is intended as general information only and does not consider the circumstances of any investor.

Gemma Dale: three ways 'retail' is not the dumb money

28 October 2020

Gemma Dale is Director of SMSF and Investor Behaviour at nabtrade, NAB's online investing platform.

GH: In this extraordinary year, what have your clients been doing, especially in the hectic days of March and April, and what's happened since?

GD: Yes, it's been a fascinating year. Volumes started low in January and February as the market was quiet. The cash accounts of our clients were at record highs so it wasn't as if people didn't have the money to invest. They were waiting to put money to work but didn't see much to interest them.

GH: Then the reality of COVID hit and everything changed.

GD: Yes, but what was most exciting was that the common view that retail investors panic when markets fall and go to cash at the worst possible time, then miss the first 20% of the upside when the markets bottom out, that wasn't correct. This idea that retail investors are not good at managing their own money because they have too much emotion in investing doesn't play out with our clients. And this is not just during COVID, but over the last four or five years of market pullbacks. Although other falls were not as severe, they start buying on falls. The one that springs to mind was when Domino's was hammered in the press in 2018 and 2019 and fell below $40, and it's now nearly $90.

GH: And this is genuine 'retail', not institutional money?

GD: Yes, nabtrade clients, we don't serve institutions. Obviously, a stock like Domino's was one they wanted to buy. They jump into stocks considered either core of their portfolios like banks or opportunistically exciting.

GH: So what happened in March and April?

GD: Two major things. One, clients started buying like mad. Our buy/sell ratio is usually around 50/50, or slightly more buys than sells because people are building portfolios, although there are pension funds expected to run down their portfolios over time. But we saw the buyers swing up to 70 to 80% of trading activity. So the proportion of both value and number of trades that were sells dropped heavily and people were not selling at the worst time. They were buying and since it was a super-sharp correction, they moved really quickly.

And then the second thing was a huge number of new entrants to market. We saw a five-fold increase in new applications in March and a three-fold increase in April over our average numbers. And then that continued right through, in fact, our biggest trading day was in June.

GH: Was it much busier for all of February to June?

GD: March was the absolute peak of monthly trading value, April was also really strong, then there was some profit-taking in June. Some people had done unbelievably well and were taking some money off the table.

GH: And to finish the year-to-date, has it been more subdued since June?

GD: Much more like normal trading but here's the third thing. Clients weren't just spending the cash on the sidelines from the cash product on our platform, where people keep cash ready to go. Huge amounts of cash came in from other sources and cash is still very high. We have investors not sure that markets will stay at this recovered level and if prices fall again, they have the money ready to go.

GH: That's a strong counter argument to the prevailing view on the way retail reacts.

GD: It's such a good story. I've been saying for five years that retail investors are smarter than the market thinks they are. A lot of the behavioural research on this is historical, some of it goes back 20 years. Investing has changed. The first share I bought when I was 18, I had to find a broker in the Yellow Pages, and look for the share price in the newspaper. I had no idea what I was doing. It was difficult to find information so there was plenty of dumb money. Now, what you find on nabtrade and other platforms and media is real time data and education and quant research from Morningstar like a professional investor has. People are not in the dark and they can respond quickly.

GH: And all this activity includes SMSFs?

GD: Yes, and although SMSFs are only about 7% by number of our clients, they are about 35% by value. We do have a lot of younger investors coming through and there are now more females than in our older clients.

GH: And what have people been buying and selling in recent months?

GD: Let's insert a table of the Top 10 by demographics.

	Baby Boomers and older (born before 1964)		Gen X (1965-1980)		Gen Y (1981-1994)		Gen Z (1995-2004)	
	Stock	% Buy	Stock	% Buy	Stock	% Buy	Stock	% Buy
1	NAB.AU	82%	NAB.AU	79%	NAB.AU	83%	NAB.AU	87%
2	WBC.AU	76%	WBC.AU	78%	QAN.AU	79%	QAN.AU	83%
3	ANZ.AU	74%	QAN.AU	81%	FLT.AU	79%	CBA.AU	87%
4	CBA.AU	84%	ANZ.AU	75%	Z1P.AU	73%	FLT.AU	85%
5	QAN.AU	84%	CBA.AU	80%	WEB.AU	77%	Z1P.AU	77%
6	FLT.AU	83%	FLT.AU	80%	WBC.AU	82%	WBC.AU	87%
7	BHP.AU	82%	WEB.AU	76%	APT.AU	62%	VAS.AU	94%
8	WEB.AU	81%	Z1P.AU	72%	CBA.AU	84%	WEB.AU	82%
9	WPL.AU	85%	APT.AU	61%	ANZ.AU	78%	ANZ.AU	84%
10	Z1P.AU	77%	BHP.AU	78%	VAS.AU	92%	APT.AU	65%

(Note that a person must be over 18 to open an account so in theory, 2002 is the latest year in which an investor can be born. It is not known how often parents use a child's account).

It's fascinating that the generations are almost identical, except very young people invest in twice as many ETFs as all other people, at about 12% of trades. And see Flight Centre, Qantas and Webjet. They were popular during the crisis because investors felt they would get rescued and they were great buying opportunities. And Zip and Afterpay of course.

GH: So the educational work on ETFs is reaching younger people?

GD: Young people understand diversification and they see ETFs as an easy solution. They have a strong tendency to buy and hold. This hypothesis that they're just day trading and they're just buying up tech, we just don't see it. Maybe we would not be the broker of choice for a young trader who wants super cheap execution, below the cost of providing the service, where there is a link to chats and rewards and CFDs.

GH: The overall data shows much stronger interest in global ETFs, but are you seeing much in direct equities, into global shares such as Apple, Microsoft and Amazon?

GD: Number one is Tesla in global stocks, but it never cracks the top 10 of total stocks.

GH: nabtrade's site carries a lot of content and educational material. What do people like to read about?

GD: Stocks that are widely held with a high-conviction view on them, either positive or negative. Stories on Telstra, the banks and CSL. Afterpay and Zip. Podcasts have become popular, but a wide variety of media works, including video. People like to consume in different ways.

GH: And the podcast that you host, Your Wealth, how has that been going?

GD: We've had some wonderful guests and the audience has increased tenfold in 12 months, depending on the guest and the topic. We've found people are happy to consume lengthy content so long as they can listen to it and do something else as well.

GH: So you're not seeing much of the 'Robinhood' effect here, where young people are punting the market instead of playing e-sports or because they are bored in lockdowns?

GD: We've had many conversations with the regulator about this. It's not an amusing side story for us as we watch it really closely, make sure that this is not the kind of behavior we're seeing. Neither nabtrade nor ASIC wants to see young people blowing up their money, particularly when you link it to the ability to withdraw superannuation. That would be an absolute heartbreak.

Although we may not be the broker of choice for this day trading anyway, the most telling statistic I can give you is that if anything, new investors are more conservative than existing clients. An older person with $200,000 in shares might put $5,000 into something speculative, but our young clients will not speculate with all their savings.

Anyone who wants to trade options must take an assessment and sign an agreement, but there's little of it with us. It's confined to experienced and wealthier investors for downside protection or income rather than by new investors. At certain times, the 'bear' ETFs have also been popular. And on shares generally, people need to have the cash in their account in order to trade. We're a 'cash up front' business.

GH: Last question. Many of your clients who have done really well in recent months and maybe now feel like they know how the stock market works. Are you worried about them?

GD: Perhaps it was a once-in-a-lifetime buying opportunity where it fell so quickly and then recovered, unlike in the GFC which took 12 years to grind back and picking the right stocks was difficult. So if this was a first experience, some people may think it's normal. My biggest fear is a slow grind of losing money say if we don't get a vaccine for some time. How will people cope with losing money day after day as a new experience? That will be a bigger test than what happened in March when we had an obvious catalyst.

Gemma Dale is Director of SMSF and Investor Behaviour at nabtrade, a sponsor of Firstlinks. Gemma is host of the Your Wealth podcast. Any advice contained in this information does not take account of your objectives, financial situation or needs.

Video: Noel Whittaker on investing until you're 100

4 November 2020

Most people underspend in retirement as they do not know how long their money needs to last. There is no magic formula to address this but stay invested in growth assets and focus on health and relationships.

At any point in time, regardless of the existence of a severe event like COVID-19, the outlook is always unclear and range of outcomes uncertain. Rather than speculate about markets, it's better to stay the course with a diversified portfolio based on your attitude to risk. Author and personal finance expert Noel Whittaker talks with Graham Hand.

View Graham Hand's discussion with Noel at the Morningstar Individual Investor Conference, 30 October 2020 here.

Noel Whittaker is one of the world's foremost authorities on personal finance and an international bestselling author. His latest book, Retirement Made Simple, is available at www.noelwhittaker.com.au.

Video: How Chris Cuffe finds fund managers who 'swing the bat'

4 November 2020

Chris Cuffe has spent four decades selecting fund managers for multi-manager portfolios, and he explains what he looks for and why active management can work, as well as updating his investment lessons.

After 40 years inside the world of managing investments and selecting fund managers, Chris Cuffe summarises his experiences into a few quick lessons. His observations are not the traditional cliches about past performance and management styles, but what really works when selecting investments.

View Graham Hand's discussion with Chris at the Morningstar Individual Investor Conference, 29 October 2020 here.

Chris Cuffe is Founder and Portfolio Manager of the charitable trust, Third Link Growth Fund and Chairman of Australian Philanthropic Services. He is the Co-Founder of Cuffelinks, the predecessor to Firstlinks, and sits on the boards and investment committees of many companies and family offices. The views expressed are his own.

Bill Bengen, creator of the 4% rule, on his own retirement

11 November 2020

(This is an edited version of an interview by Michael Kitces, who is widely recognised as the publisher of the #1 financial planning blog in the United States. His website, kitces.com, is also home to the popular 'Nerd's Eye View'. See end credits for more details).

Bill Bengen is the former owner of Bengen Financial Services, an independent advice firm based in Southern California. He's known as the father of the 4% 'safe withdrawal rate' that he put into practice.

Bill discusses how he first developed the safe withdrawal rate research, the retirement problem in the early 1990s that he was trying to solve, how Bill integrated his 4% rule into his financial planning business, and why he didn't actually use the 4% safe withdrawal rate with his clients.

Michael: The research that you did around retirement withdrawals – what I think now we collectively call the 4% rule – has been around for more than 25 years since you originally published the article on it.

So talk to us now about the evolution of the 4% rule research that you did. What was going on at the time that made you say, "Okay. I want to do some research and write a paper about this and take a swing at what I think is going on with this retirement thing?"

Bill: Yes, I can tell you, the last thing I wanted to do with a fast-growing practice was to get involved in a research project that would take several thousand hours of my time, evenings, and weekends. But clients were coming to me and they were asking, "I want to save for retirement. How should I save? How much should I save? And then, when I go into retirement, how am I going to spend this money? How do I set my investments up?"

I just completed a CFP course within the last year, 18 months. That's about 1993. And I couldn't recall anything in any of those textbooks that addressed these issues. I spoke to people and I got a lot of different answers. There seemed to be rules of thumb based on vague experience. No one had any definitive analysis that I could find. So I said, "I guess I'm going to have to do it." So I just got out my computer and my spreadsheet, got a copy of the Ibbotson data and started cranking numbers. That's what it came down to.

Michael: And so, can you set the context for us at that time? What were the rules of thumb and things going around at the time that you were looking and saying, "Yeah, this isn't cutting it, we got to go a little deeper on this?"

Bill: Well, some people said the average portfolio return is what, 7.5%? A 60/40 over time, so you should be able to take out 6%, 7%, no problem. A lot of people said, "Oh, my goodness, you're in retirement now. You have to be in bonds, 100%. You can't afford the risk of the stock market. What are you thinking?"

And of course, when I get into the data, neither one of those positions turned out to be viable. They were both wrong.

Michael: How did you ultimately come to this number of 4%? What made 4% the magic number that says this is the one that Bill has dubbed safe for all of us?

Bill: Well, I experimented with portfolios of different allocations and took the withdrawal rate down until I got a portfolio that lasted 30 years. And at that time, I was only working with two asset classes, basically, large company stocks and treasury notes. And I got a number of 4.15%. I created this chart and I looked at it and I said this is amazing because the withdrawal rate is the same over a very wide range of stock allocations, I think between 45% and 75%, it was about the same.

So at that point, it didn't appear to make too much difference what you choose. But I knew that a very heavy stock allocation was bad and a very low stock allocation was bad. So I came out with a number and, of course, that number has haunted me for years since then because you know that one number cannot represent the experience of so many different retirees. There's just too many dimensions to the problem to have a one-number solution.

Michael: And to think you went out with the thing that became so popular, people started calling it a rule of thumb and saying that's ridiculous because it's too generalised.

Bill: Yes, I don't think I ever used the term '4% rule'. That was kind of a creation of the media. When I got introduced to the media, they wanted something simple to present to their readers. And they focused on that and said, "This is the answer," like a tic-tac-toe game, put the X here.

Michael: A lot of people will point out like, "But Bill, we only get half a percent on some of our bond returns right now. When you were doing that research, you could get 6%, 7% to 8%." It's like, "Yes, but when you were doing the research, we were coming off double-digit inflation environments not that many years before.

So when you start looking at things like real rates of return after inflation, we may be in a somewhat lower return environment, but they're not nearly as low a return as sometimes we make it out to be because we look at the nominal and forget the real.

Bill: Yes, I absolutely agree with that. I think it's an overreaction. I haven't been able to develop scenarios myself in our low inflation environment where it goes below 4.5%. So I'm not sure where those concerns are coming from. I haven't seen the background work behind those claims, those concerns.

Michael: So I guess the big asterisk to the whole thing about 4% rule and that original research is just, today, we do have more investment opportunities. We own more than it – lower than two-asset class portfolio, large cap U.S. stocks, intermediate U.S. government bonds, and nothing else. And I guess it's no great surprise, or as we know from modern portfolio theory, in theory, if we have more diversified portfolios, we can get better risk-adjusted returns. And I guess, when you put the safe withdrawal rate lens on it, you get a similar effect, more diversification and less volatility for a unit of risk. And then, you end up with more retirement income sustainability, and your 4% rule becomes a 4.5% rule.

Bill: One thing I noticed when I introduced the small cap stocks, because they're much more volatile asset class than large caps, where before I had a very wide plateau between 45% and 75% stocks. It narrowed it down to 50 or 60 as being the optimum equity allocation.

Michael: Interesting. So as you got more diversification in there, it kind of narrowed in like here's really the optimal balancing point of enough but not too much on the risk spectrum.

Bill: Exactly.

Michael: So I am curious then, what did this look like in practice with clients? Was this something you used in practice with clients? Was this like cool research but we still have to do it other ways when you get down to individual client's circumstances? What did the 4% rule or 4.5% rule look like for you as a practitioner with clients?

Bill: Well, when I started my practice, I didn't actually have too many clients in retirement, okay, they tended to be closer to my age and only in the later years of my practice. But clients liked the idea. They understood the basis. They read the material. They thought it was sound.

You have to be very upfront with clients and explain to them that this is not a science we're doing. Okay? It's not like Isaac Newton sitting down and developing his three laws of motion in physics, which will probably stand for billions of years into the future. What we're doing is almost a social science. We're examining the past and we have data, but we don't have an underlying theory that relates data and facts. So we can't use it to predict anything. We can only use it as a guide.

Michael: So as you went through this with clients, was the 4% rule largely your number, or did you start using 4.5% after you did your book and kind of found, "Hey, once we get more diversification here, this number goes up."? Did you have a different number you used for some clients?

Bill: I used about a 4.2% number to start. But you know every client's situation is different. I had clients that were 5.5% because they are expecting a large inheritance, let's say five years down the road, that they're fairly certain of. And I have clients who were down at 3% because they had a pension plan that had no inflation adjustment. So over time, they were going to have appreciating demands put on their portfolio to support their income stream. So, yeah, we start with four, but there's a wide spectrum around it.

Michael: As you built your business, how many clients did you find was your comfort point? When was it no more for you?

Bill: I got up to about 80 clients. I found that was about all I could handle, the real books that I had. That was a comfortable number, so I tried to keep it right around there.

Michael: Okay. So you got up to about 80 clients and kept it there. My guess is that if you leave or move or, unfortunately, pass on, you free up a few spaces. You add a few clients back in and just for you and your wife helping you in the practice that was the comfortable level of, "I can serve these clients, the income is good. We're going to hang out here."

Bill: That's right. No, even with that limited number of clients, I spent a lot of hours working nights, weekends, and I'm sure a lot of solo practitioners do that. I was younger; I've always enjoyed working hard. But if I had to do it over again, maybe I'd hold up to 60 clients.

Michael: It's the amazing thing about the advisory business, though, is just clients tend to stick around as long as we're servicing them well. They pay a pretty good dollar amount per client at the end of the day. You don't need an immense number of client relationships to have the math add up pretty well.

Bill: No, it's really, to me, it's beautiful profession. At least, it was back when I was in it. You have a very close … you feel like you're really making a difference in people's lives on a day-to-day basis, you have a direct personal contact with them, they can get you anytime they want to. And you know you have the technical skills and the support systems to do whatever they need to get done. So it's very, very, very satisfying.

Michael: And so, how long did you continue to run the practice? When did you ultimately decide you were ready to be done done?

Bill: Twenty-five years, just about, and that was 2013 when I retired. Quite frankly, I had concerns about the market, investing. I always told my clients that I would invest my money exactly as I invested theirs. As we moved into the middle of the 20 teens, I didn't think that was possible anymore. I felt I needed to get much more conservative, but I didn't want to impose that on them. Because the market could continue to go up. And so it did. So I figured I had a good run, time to cash in, go on to something else.

I did a great job when I got my clients completely out of the market in late 2008. So they never suffered the losses that other folks did. On the other side, I did a lousy job getting them back into the market after the crisis ended. If I knew then what I know now, it would have been a completely different process. But the whole financial planning profession is built around buy-and-hold philosophy, I understand that.

I think that's a mistake. I think our profession needs to be open-minded and look at alternative means of managing money and not just assume that buy and hold is the correct way to do it. Buy and hold is what I used in my analysis, my 4% rule. One thing is because it's a lot easier to analyze things than multiplicity ways you can manage money by other means. But just because I did that analysis, I told people, it doesn't mean you have to manage your money that way.

And I remember going to an FPA meeting late in November of 2008. And advisors, you know, they look like they've just been beaten to death. They didn't know what to tell their clients. They lost so much money for them. They were literally in tears. And I wasn't in that situation, which I thought was cool.

Eventually, of course, the money came back, or a lot of it. Thanks to QE. But I didn't have the process in place at that time to get back into the market. There were clear indications now, if you look at that March and April we should be heading back in there heavily.

Michael: And so, as you look at it today, you've now done literally decades of this research, you've lived it, you've lived with multiple market cycles, so I guess I'm wondering two things. One, how do you look at the 4% rule today? Is that still the number, or is it 4.5% or is it 5% or is it something else?

Bill: I think somewhere in 4.75%, 5% is probably going to be okay. We won't know for 30 years, so I can safely say that in an interview.

Michael: And you think of that paired with, it sounds like, with a more conservative allocation, at least for the time being given where valuation is?

Bill: Yeah, I think in the course of my career, to avoid large losses, yes, with the thought that if the market were to return to historically reasonable valuations, let's say, high-teens, mid-teens in the Shiller CAPE. Then I would look in to get very, very aggressive in stocks. Maybe higher than 50% to 60% I would recommend because there are very few sources of reliable income. And fixed-income investments are giving me nothing. So, I thought I'd go to 80%, 70%, 80%, 90% dividend-paying stocks if I could get them at cheap enough prices. I'm not concerned about safety. Because if you buy something at the right price, you're good for many years. So that's kind of a radical change in my view, but I think that is necessitated by the times.

Michael: And all driven by this combination of low yields, which will drive you towards more stocks but low inflation, which actually gives you comfort that we don't need to be hanging out down like 2% or 3% withdrawal rates, high 4% is enough, 5% is still reasonable because at the end of the day, when inflation is this low and you're only spending a few percent, you actually don't need a huge amount of growth in your portfolio.

Bill: No, but once you get into preserving the capital, when you retire, you've got that chunk of money, you want to preserve it; you don't want it to get diminished by any substantial amount because it may not come back. It may not.

Michael: So out of curiosity, anything you've learned as a retiree, compared to what you advised retirees – does the view look different from the other side of the retirement transition as you think about the advice you gave and now the advice you'd want to receive as a retiree?

Bill: I always told my clients, they should be thinking of retirement as moving towards something, not away from something. You're not moving away from your work life. You're working to a whole new scheme of life. And that therefore you should have things, whether it be hobbies, activities that you want to be actively involved in and know what they are. And perhaps setting the groundwork for that before you retire. I've got my writing, my research, which is part of the reason I retired. I want to have more time to do all that.

And that's worked out very well. So I feel pretty comfortable how retirement … I can't even call it retirement. I'm putting in five days a week of writing. Weekends are still meaningful to me, believe it or not. It's not all one anomalous, amorphous time span. There are weekends that are workdays. And I expect that gives meaning and structure to my life.

Michael Kitces is Head of Planning Strategy at Buckingham Wealth Partners, a wealth management services provider supporting thousands of independent financial advisors.

In addition, he is a co-founder of the XY Planning Network, AdvicePay, fpPathfinder, and New Planner Recruiting, the former Practitioner Editor of the Journal of Financial Planning, the host of the Financial Advisor Success podcast, and the publisher of Nerd's Eye View through his website Kitces.com, dedicated to advancing knowledge in financial planning. In 2010, Michael was recognised with one of the FPA's "Heart of Financial Planning" awards for his dedication and work in advancing the profession. This extract is reproduced with permission.

Alex Vynokur: ETFs deliver what's written on the can

11 November 2020

Alex Vynokur is Founder and Chief Executive of BetaShares, an Australian provider of Exchange Traded Funds (ETFs) with $14 billion under management.

GH: The ETF industry in Australia has not missed a beat during the pandemic, reaching all-time highs on monthly flows with balances topping $73 billion and heading for $100 billion in 2021.

AV: Yes, it's been a good year for ETFs and our business. When we were in the middle of the March volatility with COVID, it was hard to know how investors would react. But the industry overall has been really solid, and a lot of the naysayers who were casting doubt on the robustness of the ETF vehicle have been proven wrong. They were saying all is good in a bull market but just wait until volatility and market falls kick in and then we will really see what ETFs are all about. So it was great for the industry overall and BetaShares to go through such a strong experience, always trading and completely in line with our expectations. The products have delivered what they say on the can.

GH: When you started BetaShares 10 years ago, did you expect to be at $14 billion by now?

AV: We didn't have a specific funds metric in the initial business plan, rather we focused on building a business with a sustainable competitive advantage. One good thing about COVID was the chance to reflect on the overall business and ask where we will be in another 10 years, in 2030. When I think about the industry in the next decade, it will be operating at a completely different scale. It will become more 'core' in portfolios, and increasingly ETFs are the first investment many people make.

GH: In the strong growth in the last few years, has there been a particular type of ETF which has surprised you, where four or five years ago you weren't seeing the growth.

AV: Ethical investing must be called out as the x-factor for the industry and that wasn't previously on the radar. In fact, when we started the business, I didn't even know what ethical investing was, let alone that it would represent such an important part of our growth. It's only been in the last three years that the myths about ethical investing have been dispelled. The conventional wisdom was that few people would be willing to sacrifice performance for the pleasure of investing ethically. But now the track record speaks for itself in delivering performance and it's been an eye opener.

GH: How much do you have in ethical funds?

AV: Closing in on $2 billion, and just over three years ago it was zero. We have developed true-to-label investments and BetaShares accounts for the majority of ethical investment assets in the ETF industry in Australia. Increasingly, ETFs are capturing the ethical flows, which is unique, because in all other categories, ETFs have been playing catch up with active management and unlisted index funds.

GH: And the growth in fixed interest and global ETFs has also kicked in.

AV: It has as well. Fixed interest and international are great examples of the democratisation and access that ETFs deliver. Traditionally, diversification into fixed interest was the purview of large institutions, with high denominations, opaque pricing and 'over-the-counter' trading. ETFs have taken the bond game to another level, enabling all investors to connect better with the building blocks of fixed income. In the past, bond components such as governments, supranationals, credit, corporate bonds, asset backed were, for the average investor, always a mystery. ETFs have helped to demystify fixed interest, lower the cost and improve access.

GH: I remember a Chris Joye webinar around April, talking about hybrids in the fund he managers, HBRD, with spreads at historically high levels. That's turned out to be a great investment in the last six months.

AV: There's still work to do educating on fixed interest, but if you look at COVID, investors benefited from the lower volatility of bonds in their portfolios, and ETFs have delivered the outcomes they sought.

GH: Retail investors have the same access to shares in BHP or Woolworths as professional investors, but not to the wholesale bond market where most bonds are traded.

AV: Yes, and I think international shares are in the same category. Some brokerage businesses offer access to overseas shares, but global ETFs trading on the ASX give institutional pricing in this time zone without FX fees or wide spreads. So on the ASX we have a Vanguard S&P500 or a portfolio of global cybersecurity companies through HACK or NASDAQ100 through NDQ. Full transparency and costs. All investment vehicles need to deliver value and ETFs have proved themselves.

GH: On ETF product proliferation, we now have more ETFs in the US than listed companies, giving the ability to back almost any idea. Australia now has, what, 215 and a quarter of them are yours. Is this a healthy development?

AV: Well, first of all, that's similar to saying that there are more words in the English language than letters. You can have a lot more words than letters, and you have more ETFs than individual securities. If we focus on Australia, it is a market that is far from homogenous in its participants. We have people investing for the first time, especially with the property market out of reach of the majority of young Australians today. Then at the other end of the spectrum, we have investors with significant balances, maybe in retirement, and they don't need as much growth and want strategies focused on preservation of capital. And then, the world of asset allocators who are looking for indexed building blocks for a diversified portfolio.

GH: And their needs change over time.

AV: Yes. If you'd asked me 10 years ago whether robotics and artificial intelligence would present an investment opportunity as a long-term secular trend supported by great fundamentals, I would probably not have even understood the question. The leaps that industry has made have created drivers of innovation and value creation. These are the reasons we see innovation on the product side. It will only stop if our needs as investors remain constant, and that never happens. Consider the interest rate environment that we live in today. It creates unique challenges and problems that need to be solved.

GH: I agree that the range of investment opportunities is a worthwhile development but it also means some funds will be left behind and be forced to close.

AV: Yes, but that's absolutely fair. With an industry that's maturing, we learn from hindsight, and closing products shows an ability to make a mature assessment of what has been done well and not so well.

GH: Can you identify characteristics of ETFs which have worked particularly well, and others that have not done as well as you hoped?

AV: The most important feature is the true-to-label nature of the product that delivers an investment outcome aligned with expectations. We are experiencing a significant secular trend towards lower cost, more transparency, more liquid investments, which favours index strategies, whether those indexes are market capitalisation, thematic, smart beta or strategic beta. These deliver value to investors, whether it's the core of the portfolio, an allocation to a thematic as a satellite or tilt, whether it's a country-specific or factor based. ETFs challenge the conventional wisdom of what an index really means.

GH: And active ETFs.

AV: There is plenty of scope for both index and active to coexist, and ETFs showed the benefits of intra day liquidity in active ETFs during the extremes of COVID. The Australia market would open, say, 6% down and close 3% up. A range of 9% or 10% in one day at its extremes. Investors in an active unlisted fund had no ability to time their entry when the market was down. An order through an application form or website for the unlisted fund would be filled at the end of day price regardless of when the investment was initiated.

GH: And worth noting that the ASX's solution to access managed funds via their platform, mFunds, is an execution service not a trading service. Investors put in an order that is filled after the close of the market, although the trade is done on the ASX.

AV: Yes, while on-market, investors could be filled immediately at a price that's aligned with the investors' expectations. It gives more certainty on the price, whether for a buyer or seller. It's a more-evolved investment structure whether you believe in passive or active investing.

GH: BetaShares has had a lot of success with the cash product, AAA, but what's the outlook now the cash rate has been reduced to 0.1%?

AV: AAA has grown significantly as rates have come down, and one reason is that most investment platforms now pay zero on cash deposits. People always need to have some of their balances in cash, and the relative return of AAA is probably more relevant than ever. Rates go up and down but the fund has been able to deliver rates that are more favorable than available through most cash alternatives.

GH: As recently as a couple of years ago, Listed Investment Companies and ETFs were both doing well at about $40 billion on issue. ETFs have doubled in three years and now hold $73 billion, and you are predicting $100 billion next year. What are the key differences where one has surged and the other has stagnated?

AV: The engines that power the growth of ETFs have been consistent since the beginning but the ETF industry never benefited from paying a remuneration or distribution incentive. So in the early days, ETFs were poorly adopted. Before FOFA, it was not a level playing field. The enforcement of FOFA rules through the Royal Commission has affected those structures like LICs which relied on paying for distribution. With a level playing field, ETFs prosper.

GH: If you were talking to an investor who already has the core of a portfolio covered with broad-based Australian equities, global equities, property and fixed interest, but wants to put 5 to 10% of their portfolio into something that's a little bit sexier and maybe a little bit riskier ... If you had to choose a couple of funds that you feel best about, what would they be?

AV: Two good candidates. One is Asia tech, ASIA. It's a great portfolio of high-growth companies with true bottom-up growth and innovation, such as Tencent, Alibaba and JD.com. It holds the 50 largest stocks in technology in Asia. The other one is cyber security, HACK. I think as we go cashless globally, the focus on digital wallets will demand protection of personal data, corporate data and government information. It's only just beginning and is the most exciting thematic in my view.

GH: Last question. The business has done well but what worries you the most? As Bill Gates once said, two smart guys in a garage can kill Microsoft.

AV: Yes, that's right, exactly. I ask myself what could derail the growth of ETFs, especially since at the moment, we are the disruptors of the asset management industry. ETFs make the lives of mediocre active managers miserable, but what can disrupt us? It would be a mistake to believe for a second that the ETF industry itself is immune from disruption and challenge.

That's the one thing that I am paranoid about. Not because there's anything on the horizon today but success can breed complacency. We've been blessed by our timing but we must retain the hunger, the innovative edge. A dose of paranoia about the needs of our clients and evolving with the times will prevent us becoming a dinosaur.

Alex Vynokur is Chief Executive Officer of BetaShares Capital, a sponsor of Firstlinks. This material has been prepared as general information only, without reference to your objectives, financial situation or needs.

Steve Bennett on investing in direct property for the long term

25 November 2020

Steve Bennett is Chief Executive Officer at Charter Hall Direct and was elected President of the Property Funds Association in April 2019. He oversees in excess of $6 billion of direct property investments.

GH: Which property sectors have been most and least adversely impacted by the pandemic?

SB: Most sectors have been impacted in some way if you look at it from a foot traffic or tenant usage view. Most adversely are the large discretionary shopping malls, which were hit by the lockdowns. Plus places like Melbourne office buildings where the State Government mandated people to work from home. And then the least adverse are assets such as Bunnings which in most parts of the country continued trading strongly through the pandemic, and industrial assets have been positively impacted. When people order things online, it doesn't just magically appear with click of a button. It comes out of a warehouse and goes onto a truck, and industrial logistics is a long-term trend and the pandemic has really speeded it up.

GH: Did Charter Hall make any lease adjustments, especially in the beginning around March and April?

SB: Not really. We've been fortunate in two main ways. The first is that the whole Charter Hall Group focusses on long WALE (Weighted Average Lease Expiry) properties as a thematic. So we haven't renegotiated any material leases that were up for expiry because they are pushed well into the future. And secondly, the Group focuses heavily on government and highly-rated corporates. These are financially-strong counterparts which don't need special treatment.

Where we've had to be accommodative is for SMEs who were suffering financial hardship or stress. Under the Government's National Code of Conduct, SMEs were provided some rent relief to help our smaller tenants come through the other side. It's in everyone's interest.

GH: Could you give an example of a type of tenancy and property where you relaxed the lease terms?

SB: If you think of a large premium-grade office tower, typically there's a coffee or a sandwich shop in the foyer. And when the foot fall through CBDs plummeted, we needed to help with the rent because everyone wants the amenity to stay there, particularly for the operators who were trading well and had always paid the rent. And in non-discretionary retail, such as in neighbourhood centres anchored by Woolworths or Coles, we've helped some of the smaller specialty stores although most of the food operators have traded well.

GH: Many of our readers will be familiar with residential leases, but can you highlight some ways a commercial lease normally varies from a residential lease?

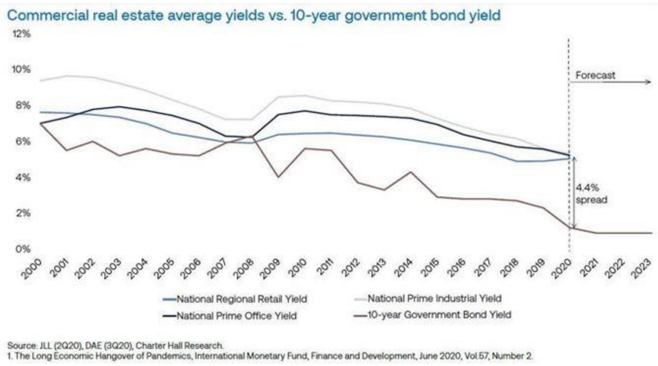
SB: There are three big differences. First, the length of the lease. Most residential leases are six to 12 months, while we have leases to governments and major corporates such as Woolworths and Coles for up to 20 years. Our office fund's average lease term is eight years and industrial fund is over 10 years. The second is the income yield. Most of our funds are paying somewhere between 5.5% to 6.5% per annum income whereas if you're getting 2.5% to 3% in residential, you're doing well. Plus commercial leases are typically net leases where the tenant is responsible for all the costs. So the return is after all those costs are paid whereas in residential, the landlord has to cover body corporate fees, sinking funds and agents fees, and that's just the start.

GH: Tell me about it, I should sell my investment apartment this afternoon.

SB: Exactly. There's a place for residential in some portfolios but commercial property stacks up well for investors who want diversification and to avoid the hassle of a single, short-term leased residential asset.

GH: Across the many property sectors you cover, where do you see the best opportunities?

SB: The best opportunities, and we're hearing this from institutional investors globally, are the long lease assets with some type of a monopolistic feature, such as a long lease Bunnings in a great metro location. They are well bid by almost everyone from high net worths to institutional managers. And a long lease asset regardless of the sector with a very strong tenant will continue to do well. For example, we own a new office building at Macquarie Park with a 10-year lease to the New South Wales Government and it's throwing off 5.5% income. In a world where interest rates are close to zero or negative in real terms, it's easy to see why that style of property is popular. As the chart below shows, the yields spread between commercial real estate and government bonds is wider than ever.



GH: Where is that office asset held?

SB: That one is in our Direct PFA Office Fund, open to SMSFs and high net worth investors.

GH: What are your expectations on the medium- to long-term consequences of working from home changing the city office market?

SB: We think there are huge advantages in working in an office for collaboration, risk management, providing experience and guidance to younger team members, networking, and obviously the amenity that you get in a CBD location. Having said that, the trend to working from home has been bubbling away for a long time. So, it's undoubted that home will form part of the way we work in future. We believe businesses will provide additional flexibility, so staff might work for a day or two a week at home.

The previous process of 'densification', a fancy word of putting more people per square metre into an office, is now reversing, and this move back to lower density will balance working from home. But we are also going through a recession so we shouldn't kid ourselves that in the short term, there will be a reduction in white collar jobs. It shows the value of a long lease strategy.

GH: WFH has its productivity benefits but it's more difficult to have a collaborative discussion about a complex subject between five or six people on Zoom than it is sitting around a table.

SB: I couldn't agree more. We were launching and refining a new product through COVID and what would have taken one maybe two meetings with the right people in a room and a whiteboard required endless Zoom calls. We speak to a lot of CEOs because of the nature of our business, and there's a consensus building that their companies are losing some of the culture that they've built up over many years. How are junior people going to learn if they are not sitting with their team? I think one of the reasons for the claimed success of working from home is that it's self-reported.

For thousands of years, we've had migrations into cities. We've had pandemics before. We're not going to stop the ways we interact and live because there is value in it. I laugh when I read some of these tech companies, the Googles and Facebooks, say they will never have people in the office and then Atlassian announces it will build a billion-dollar property in the Sydney CBD. If it is so unimportant, why do the tech companies group themselves together in Silicon Valley?

GH: Stock market volatility has been extreme in the last six months, and the share price of the Charter Hall company is no exception. January $14, March $5, now back towards $14. Is it possible for an executive to distance from what is happening with the market's assessment of the value of your company and does that lead to caution in your activities?

SB: It's one aspect we love about unlisted properties. We don't get caught up in the sentiment that can infect listed markets. There's a lot to be said for experience as well. I was in London with Macquarie throughout the GFC when the share price went to low single digits. The feeling around the office was that the company was trading through a potential existential threat and the bank guarantee from the government helped pull the banks through.

I never saw anything like that at Charter Hall. We knew the business was extremely sound, we understood how the funds are set up with long lease terms. In fact, some executives picked up more shares in the company as the low price just didn't make sense. It was a classic equity market mispricing, and it can happen on the upside and the down. If I compare the two experiences, this year and during the GFC, everyone just got on with it this time.

GH: Charter Hall has been on an acquisition drive for many years. Has it continued this year?

SB: If anything, COVID gave us more impetus around the long lease, high quality strategy. We used the opportunity to pick up assets that we probably wouldn't have been able to obtain at such favourable prices, especially in industrial logistics in the September quarter. We also picked up a portfolio of Bunnings. It's the advantage of having capital to deploy and looking through the cycle with people on the ground to do inspections. We're also the biggest player in sale and leaseback, helping companies free up capital from their balance sheets and giving us assets to meet the needs of our investors.

GH: So for a Firstlinks reader, perhaps the trustee of an SMSF, with a traditional portfolio of cash, domestic and global equities and fixed interest, but looking to deploy funds into other asset classes, what are one or two of your funds for that sort of a portfolio?

SB: First, they should recognise that quality sources of income will be even more highly valued in the medium to longer term due to where interest rates are. We've got a diversified fund called the Charter Hall Direct Long WALE Fund paying 6% per annum income, paid to investors on a monthly basis. And we have a highly-rated industrial fund, DIF4, with a similar distribution yield, average lease term of 11 years and occupancy rate of 99%.

GH: They are both unlisted?

SB: Yes, and investors should consider whether every part of their investment portfolio needs to be liquid. These funds give high quality income streams from core real estate, and they have low gearing. We could increase the distribution yields by simply putting more debt in but we believe that a gearing range of 30% to 40% is the right place to play.

GH: Is this an unlisted version of the listed Long WALE REIT (ASX:CLW)?

SB: It's a similar diversified fund but holding different assets and much smaller than CLW at this stage. We mix assets from office or retail or industrial to take advantage of diverse opportunities as they arise. And I'll just add that we have over 15,000 direct investors in our funds and we're supported by over 1,200 financial advisers. We manage more third-party capital in commercial real estate than anyone else in Australia.

Charter Hall's free ebook 'Your Guide to Investing in Australian Commercial Property' is linked here.

Steve Bennett is Chief Executive Officer at Charter Hall Direct and was elected President of the Property Funds Association in April 2019. Charter Hall is a sponsor of Firstlinks. This article is for general information purposes only and does not consider the circumstances of any person, and investors should take professional investment advice before acting.

Evan Reedman: Australian ETFs from slow burn to rapid fire

15 December 2020

Evan Reedman is Head of Product and Portfolio Review Department at Vanguard Australia. Globally, with $9 trillion in assets under management as at 30 September 2020, including about $2 trillion in Exchange-Traded Funds (ETFs), Vanguard is one of the world's largest global investment managers.

GH: How would you describe the usage and acceptance of ETFs in Australia now versus five or 10 years ago, in both retail and institutional markets?

ER: Initially, we had a slow and steady burn, but in the last few years, investors have become comfortable with ETFs as an investing vehicle. Initially, support came from financial advisers, but increasingly, individuals are using ETFs for themselves. This year has seen record inflows in what was supposed to be a difficult market, with Australian ETFs rising about $5 billion in November 2020 with net inflows a record $2.5 billion. There is now $92 billion invested in ETFs in Australia. Investors now accept that ETFs are ideal for broad market exposure in a single trade for a relatively low cost, and that's what most ETF strategies provide.

GH: What have been the best two or three funds for inflows within the Vanguard range, and which haven't done much?

ER: Unsurprisingly, as we see in every market, the home bias funds do the best, which for us is the Vanguard Australian Shares ETF (ASX:VAS). It continues, year in year out, to be the most popular ETF that we offer, and is now sitting at about $7 billion. The others that have done well are the Diversified ETFs. People are looking for portfolio solutions and the diversified funds are a pre-packaged asset allocation solution.

The least popular are harder to identify as we have launched some new ETFs which still have small balances, but that does not mean they are out of favour. They are still finding their feet.

GH: Next year is Vanguard's 25th in Australia. For many years, your products were all unlisted managed funds with no ETFs but now I'm guessing ETFs receive the most flows. Is that correct?

ER: It's really been in the last two to three years that ETF flows have exceeded managed funds, for a couple of reasons. One, investors are now comfortable with the structure. And two, many of the businesses that we partner with in the industry, particularly financial advisers and platforms, have evolved their technology to suit holding ETFs as their preferred vehicle.

GH: How do you manage the different price points facing investors when they invest in Vanguard through a managed fund or ETF?

ER: Some of the price differences reflect the manufacturing and distribution costs of those products, and the mechanics of how they work, such as payments for registries or to index providers. So while we strive to offer the most competitive price points in the respective products, there are some price differences. We leave it to the adviser and the client to make the choice based on what suits them, depending on the platforms or systems they use.

One example is that a platform might facilitate a regular savings programme more efficiently than buying small amounts of ETFs and paying brokerage each time. We're agnostic, it's up to the client.

GH: Part of your title is 'Portfolio Review Department'. What does that do?

ER: It's Vanguard's eyes and ears to the market. We focus on what we call 'fund health'. It's not a matter of just putting a fund on the shelf and leaving it, but ensuring the products are operating efficiently including reporting to the Vanguard Board and the Global Investment Committee. We try to take a dispassionate and factual assessment on how they are performing. You might think of it as an 'in-house asset consultant'.

GH: Vanguard has a global reputation for index or passive ETFs but you also offer active funds. How do you reconcile the two?

EV: In Australia, we have two active equity products with sub-advisers Baillie Gifford and Wellington. We bring what we consider the best capabilities to the market and Vanguard has been working with some of these external managers for 40 years or more. The fund might be called the Vanguard Active Global Growth Fund or the Vanguard Active Emerging Markets Fund, for example, but we make it clear that there is a sub-adviser.

GH: Why does Vanguard focus its ETFs on broad market exposures rather than thematics or niche products?

ER: We need to have an economic reason for a product that meets a long-term investor outcome. The investment case must be strong and enduring for the needs and preferences of our primarily retail and intermediary clients. So we ask, 'What problems are investors trying to solve?' And we focus on their retirement goals or having income to spend in retirement. It's a different approach to some in the market which means we launch fewer products but it also ensures longevity in our product suite as well.

GH: Would you avoid a product which looks like it will generate good flows if you think it's only likely to be fashionable for a year or two and maybe not be in five years?

ER: That's the sort of thing we do. We err on the side of saying that we're okay if others want to play in that space or offer a product but if there is any doubt about the longevity of the fund or even how it might be used by particular clients, we stay away.

GH: So we won't see the Vanguard Crypto Fund?

ER: It's funny how often I am asked about crypto or gold or inverse ETFs, but you will never see those from Vanguard. I'm not making any judgment on others, it's about product philosophies and who we are.

GH: Even with the current ETF income range, a lot of retirees are struggling for income. To what extent does Vanguard believe this can be solved by going down the risk curve, say into non-investment grade securities, or does the risk problem prevail?

ER: We still need a compelling economic rationale and we take a long-term approach to achieving outcomes. So first I'd say people should be taking financial advice. And second, investors should understand exactly what they are invested in, check the way their portfolio is constructed and ensure that what they are holding is true-to-label in order to allow them to ride out a short-term reduction in income. Unlike many active managers, we replicate a stated benchmark in our index funds and ETFs, so would not be moving up and down the risk curve.

GH: Does Vanguard feel compelled to respond when another ETF provider launches a similar fund at a cheaper price?

ER: Our overall pricing philosophy in both managed funds and ETFs is to provide the best value to our clients with a high-quality product. But obviously we are running a business and we need to make money, so we focus on the long-term return to ensure Vanguard in Australia is a sustainable business. We watch what our competitors are doing but sometimes they may be using a different index or third-party service with different input costs. There are various price points where iShares or BetaShares have lower prices on similar products but we don't have a philosophy that says we have to be the cheapest. It's the final net outcome to the client that matters most. Value for money does not always mean the cheapest.

GH: As Head of Product, how does your role overlap with other people in Vanguard?

ER: Two major project teams which my team are currently working very closely with include our Personal Investor team as we continue to grow and enhance our new digital retail offer, and of course the team building our new superannuation offer, But naturally the product team has close ties with all other areas of the business managing our offer to investors.

GH: It's extraordinary that there are now more ETFs in the US than there are stocks. Are you concerned that development has gone too far, that it's not healthy for the ETF industry to have so many funds which inevitably means many will also close each year?

ER: We don't think we should test our product ideas on clients' retirement savings. It's up to us as investment professionals to ensure there are enduring reasons why we're offering a product to clients and it's not just to make a sale. So I do get concerned and I hope we do not see a repeat of the US experience in the Australian industry where every investment idea becomes an ETF.

GH: Finally, what major trends do you identify for the future growth of ETFs?

ER: Something that's moved from the institutional space to individual investors is ESG investing. The environmental, social, governance and ethical ways ETFs are constructed continue to grow at pace. Advisers and clients are really looking for these funds now. We recently launched an Australian Ethically Conscious fund based on the ASX300 but using a FTSE methodology and not the S&P index that we use for VAS. It's still small, obviously, but attracting good retail flows in its first couple of months of trading.

Evan Reedman is Head of Product at Vanguard Australia, a sponsor of Firstlinks. This article is for general information and does not consider the circumstances of any individual.