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Editorial

The best investors have a similar trait to the best gamblers: they bet when the odds are overwhelmingly in their favour.

Former 'bond king' Bill Gross, of Pimco fame, discovered this at an early age.

His path to finance began by chance. He was in his final year of college when he had a car accident which sliced open his scalp. While bedridden, he read a book called Beat the Dealer by Edward Thorp, who was then a maths professor.

Written in 1962, the book detailed how you could win at blackjack by using a system for counting cards. When Gross recovered, he went straight to Las Vegas, where he played 16 hours a day over the next four months. He turned his initial US$200 into US$10,000.

Once done, his thoughts turned to what to do with his future. He later recalled:

"I said, well, I obviously enjoy mathematical application of a system of some sort, and hard work, and diligence. What's the adult form of gambling? It's the stock market. Maybe you can't outfox it, but let's see if it can be done. Right then and there I said, 'I'm getting into the money management business.'"

The rest is history.

Randomised luck versus systematic edge

Most people think of gambling as randomized luck. And they're largely right. At a casino, the casino normally has the advantage.

For instance, you can go to a casino and play blackjack. The dealer will give you, and all other players, two cards face up, while the dealer gets one card face up and another face down. From there, the aim is to get as close to cards totalling 21 as possible, without going over.

But your chances of winning a hand are 42.22%, while the odds of a tie are 8.48%. Conversely, the odds of the casino winning are 49.3%. That's because the casino dealer has the advantage of going second and can make decisions based on your position. You may get lucky for a few hands, yet if you play long enough, the statistical odds will come back to beat you.

Bill Gross wasn't interested in relying on randomized luck though. When he read Thorp's book, he saw a system of counting cards that could tilt the odds in his favour. He then applied that odds-based mentality to give him an edge in bond markets.

'A man for all markets'

Edward Thorp went on to have an amazing career too. He wrote 'Beat the Dealer' when he was 30 and the book not only inspired Gross but generations of professional and amateur gamblers. Several students at MIT successfully used the card counting method, and their exploits became the basis for the 2003 best-selling book, Bringing Down the House, by Ben Mezrich, and subsequent film, "21", starring Kevin Spacey.

After Thorpe's book was published, several wealthy individuals bankrolled Thorp so he could apply his system at casinos. He was originally welcomed by casinos as they didn't see him as a threat. As his fame spread, Thorp started wearing disguises, but the mobsters who ran the casinos at that time were onto him and fought back (through violence and other means).

The public corporations which eventually took over the running of casinos from mobsters became smarter at eliminating card counting. They altered table rules to discourage gamblers from counting opportunities.

With the money he'd amassed from gambling, Thorp began investing in the stock market. He figured gamblers and investors shared the same psychological makeup. He developed a system based on arbitraging the price differences of two correlated securities, such as a company's shares and its warrants.

He outlined his system in the book, 'Beat the Market', in 1967 and formed a hedge fund in 1969 to put the theory to work. Over the next 19 years, Thorp's hedge fund returned 20% per annum, or a cumulative 2,734% compared to the S&P 500's 545%.

In 1991, Thorp was a consultant to hedge funds and a client asked him to review his portfolio. Thorp approved the portfolio with one exception – an investment in a hedge fund run by a guy called Bernie Madoff. Thorp saw that Madoff's returns were fake. 17 years later, Madoff was indicted for a Ponzi scheme worth almost US$65 billion. Thorpe said he didn't blow the whistle on Madoff as he owed a duty of confidentiality to his own client.

Buffett's edge

Before Thorp, Warren Buffett had developed his own odds-based system for beating the stock market. He started by following his teacher Benjamin Graham into value stocks, where he'd often buy a stock valued well below the net assets on its balance sheet. He eventually changed his investment system to focus on quality stocks valued cheaply.

As his publicly listed company, Berkshire Hathaway, got larger, Buffett started buying whole companies. He became attracted to insurance companies, which gave him two things:

- A cheaper source of funding than offered by banks or equity markets
- A way to play the odds via insurance.

Buffett realised that insurance was an odds-based system, where you price insurance according to the odds of a future event happening. Insurance has since formed the backbone of Buffett's empire.

Buffett's partner, Charlie Munger, has expressed how he uses the horse racing betting system as a way to approach investing in the stock market:

"To us, investing is the equivalent of going out and betting against the pari-mutuel system. We look for the horse with one chance in two of winning which pays you three to one. You're looking for a mispriced gamble. That's what investing is. And you have to know enough to know whether the gamble is mispriced. That's value investing."

Mohnish Pabrai's dhandho investing

Buffett follower, and successful investor, Mohnish Pabrai, has put his own spin on things with 'dhandho investing' – investing in stocks where there's a high degree of uncertainty but low risk. Pabrai suggests most investors mistakenly see high uncertainty and high risk as the same thing:

"Low risk and high uncertainty is a wonderful combination. It leads to severely depressed prices for businesses – especially in the pari-mutuel system-based stock market. Dhandho entrepreneurs first focus on minimizing downside risk. Low-risk situations, by definition, have low downsides. The high uncertainty can be dealt with by conservatively handicapping the range of possible outcomes. You end up with the classic Dhandho tagline: Heads, I win; tails, I don't lose much."

Pabrai gives several examples of low risk, high uncertainty opportunities that his fund has invested in. In 2000, he invested in a US funeral services business, Stewart Enterprises, whose stock had slumped more than 90% from its peak. Stewart had bought many other funeral services businesses (a roll-up business model) and taken on a huge amount of debt. The market was pricing the company as if it was about to go bankrupt.

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

In this week's edition ...

Michael O'Neill from IML thinks it's time to double down on dividends. He believes capital growth will disappoint over the next decade, making dividends critical to overall returns. Dividend stocks he likes include Aurizon, Metcash, Orica and Suncorp. Bruce Murphy and colleagues at **Insight Investment** agree more defensive positioning is the way forward. But they argue the case for investing in investment grade credit, which can now achieve long-term return objectives through income alone, without the drawdown risk inherent in equity markets.

Gemma Dale breaks down how nabtrade investors are already getting defensive as the new year begins. Retail investors are retaining high cash levels, and unlike during Covid, they aren't buying market dips. A contrarian signal for the brave, perhaps?

The **Mercer Investments** research team believe inflation should remain top of mind for investors. They see eerie parallels to the 1970s and like then, natural resources, energy and inflation-protected bonds should outperform.

Meantime, **Romano Sala Tenna** is fired up about the active versus passive investment debate. He thinks the question of active versus passive managers rests on the lazy assumption that it isn't possible to consistently choose managers that consistently outperform. But both the premise and narrative are flawed, in his view.

We're in a rare moment where the term premium has been negative for a number of years. History tells us that won't last, and **Shane Woldendorp** says that as the term premium returns to normal, it'll favour value-driven, bottom-up stock pickers.

Jeremy Gibson is focused elsewhere: on structural growth in the healthcare sector. He suggests the long-term outlook will increasingly be about advances in cell and gene therapies, and genomics. Companies that provide parts and services for vaccines and other therapies are uniquely placed to benefit and where he sees the biggest opportunities.

Finally, in this week's white paper, **Van Eck** highlights a global paradigm shift, through a combination of central bank tightening, decarbonisation, unprecedented sanctions and convergence of energy and security policies. It advises investors to avoid risk assets, buy bonds and avoid highly volatile and speculative equities.

Doubling down on dividends

Michael O'Neill

Market commentators love speculating on which direction markets are heading and when they're likely to turn. But while expert speculators are loved by the media, they're not much use to long-term investors. That's because any experienced investor will tell you that it's incredibly difficult to time the market – so you're usually better off not trying. What you're better off doing is looking at long-term fundamentals and trends, and making decisions on where you're likely to get the best return in the medium to long term.

When we look at the data, we think that now's the time to invest in income. Why?

Capital growth is likely to be lower in the next decade

Ultra-low interest rates and readily available, cheap, money drove a long bull market. With high inflation and rising rates, that era has passed. While markets may, or may not, perform well in 2023, what is very unlikely is that we'll enter another long bull market with a similar amount of capital growth.

Rising interest rates are driving down company earnings and company valuations. Central banks in the US, Australia and elsewhere are adding further macro-economic headwinds by continuing to remove money from the economy via quantitative tightening.

These factors should drive lower capital growth in the medium term and it's unlikely to be a smooth ride. Volatility may remain elevated in the near term. While this makes it a challenging market for investors, it also offers opportunity. With company valuations fluctuating, it's a stock pickers' market, with a great chance to pick up high-quality companies at bargain prices.

For us, with capital growth likely to be lower in the medium-long term, it's the right time to place greater focus on income.

There are different ways to generate income from an equity portfolio. In IML's Equity Income Fund we use three main streams for income: dividends, options and capital gains. We use simple options strategies to generate around 2% income yield from the portfolio – it tends to be a bit higher in flat or bear markets. We also generate up to 1% through realising capital gains – this is higher in bull markets, but we make sure we leave room for capital growth so investors can keep pace with inflation. And then we generate around 4% income yield through dividends. This diversity of income sources tends to give us a higher, and steadier, income stream paid quarterly. At the core, we still look to dividends from low-risk industrial stocks to generate the bulk of the income.

Dividends are likely to make up a greater share of total return

For us, dividends have always been an important part of investment returns, but at times like these, their importance increases. There are two main reasons why:

1. Dividends provide more reliable returns than capital gains

Returns from a share portfolio come from two sources – the capital appreciation from the shares, as well as the dividends received from each share. If you look at the table below showing returns from the ASX 300 over the last 20 years, you can clearly see how important dividends are to overall returns.

ASX 300 returns	20 years p/a
Returns from capital growth	4.4%
Returns from income	4.5%
Total returns	8.9%
% of returns from income	51%

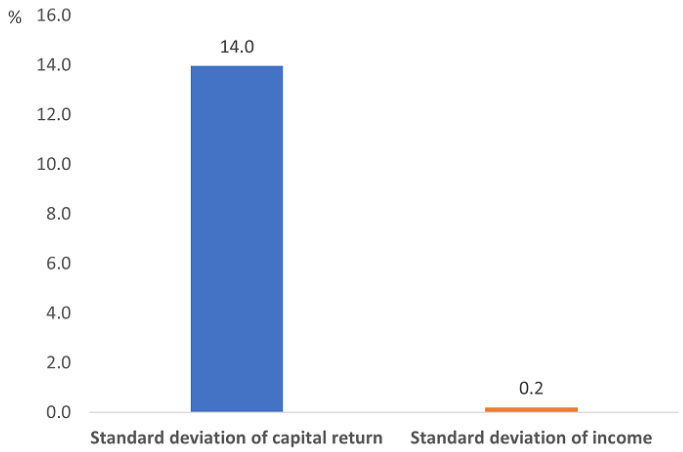
Source: Morningstar Direct, as at 30 November 2022

Over the last 20 years, dividends have returned 51% of overall returns. While this figure alone is evidence enough of dividends' importance, it becomes more striking when you look at the volatility of these returns.

As you can see, return on capital fluctuates significantly, but dividend returns are remarkably reliable – making them particularly valuable when returns on capital are low, or negative.

While the level of capital returns from a share portfolio depends on movements in individual share prices, this is not the case for dividends. That's because the level of dividends received by an investor is decided by the company's board and is generally a reflection of the company's overall profitability – its financial performance. So, in periods where the overall sharemarket goes down, an investor's dividends should stay much the same if they have a diversified portfolio made up of quality companies.

Volatility of returns of capital and income of the ASX 300 over 20 years



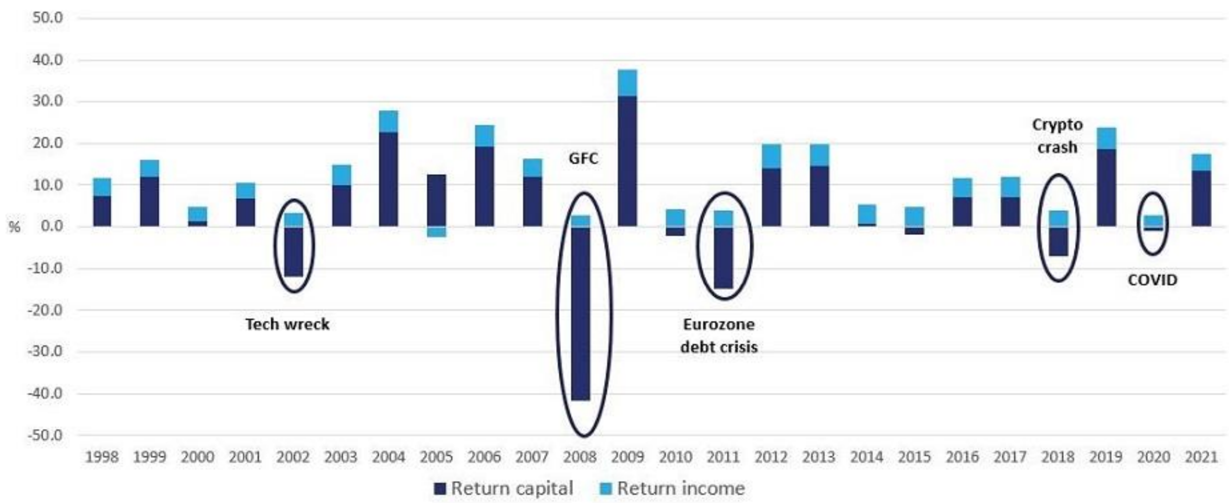
Source: Morningstar Direct, as at 30 November 2022

2. Dividends can act as a 'safety net' in times of volatility

The movement in the sharemarket – particularly over shorter time periods of 6 to 12 months - is often dictated by investor sentiment. Sentiment can be erratic, impacted by anything from predictions of future levels of economic activity, to inflation and interest rates, or perceptions of geopolitical stability.

Take a look at this chart of ASX 300 returns over the last 20 years with the light blue bars showing dividends and the dark blue bars showing capital growth.

ASX 300 returns capital vs income



Source: IML and Morningstar Direct, S&P ASX300 01/01/1998 – 31/12/2021

You can see how important dividends were during those years where the ASX dropped significantly, or capital returns were lower. In the peak of the Tech Wreck in 2002 the ASX 300 provided a return on capital of -12% but dividends returned 3%.

- In 2008, at the start of the GFC, capital dropped 42% but dividends returned +3%
- In the 2011 Eurozone debt crisis capital returned -15% but income returned +4%

And while the sharemarket recovery from COVID was very swift, the ASX 300 still dropped 1% but income? It returned a steady 3%.

When the mood of the market is negative, stocks can fall heavily as investors and traders reduce their overall level of sharemarket exposure by rapidly selling shares - indiscriminately and independent of their quality. What we have observed over many years of investing is that once sentiment starts to turn, companies with sustainable earnings that support a healthy, consistent dividend stream are often the shares that recover the most quickly.

The reason for this is simple - rational, long-term investors are always attracted to companies that pay a healthy dividend from a sustainable earnings stream. They understand that the level of returns from dividends are not dependent on future share price performance. In other words, once shares in quality companies fall to a level where the dividend yield is attractive and sustainable, long-term investors buy them so they can 'lock in' high income levels, whatever happens to the sharemarket in future.

Which stocks and sectors are likely to pay the best dividends in future?

With the economic outlook uncertain and lower growth and high inflation likely to stick around for a while, it's a good time for investors to think seriously about where they are likely to get the best income for the medium to long term. Investors should be cautious of overconcentrating in riskier sectors such as commercial property, resources, and other cyclical sectors.

We prefer industrials for long-term, consistently high dividends. We are also looking at which sectors and stocks are likely to perform well, and so provide a steady or growing dividend, in a high inflation environment. The types of companies that tend to perform well when inflation is high are companies:

- With pricing power – their strong market position gives them the ability to pass on rising costs to their customers e.g., home and motor insurance companies like **Suncorp** (ASX:SUN).

- In a rational industry – the main players are motivated by profit and act 'rationally' to maximise long-term profits – not spending large amounts of capital at the top of the cycle or chasing market share at all costs through unprofitable discounting. The explosives industry for example has rationalised significantly and is at a strong point in the capital cycle, benefitting companies like **Orica** (ASX:ORI).

- That sell essential products and services – people need to buy them, no matter how high prices go e.g., consumer staples companies like **Metcash** (ASX:MTS).

In addition to the above, companies need to have capable, proactive management that can put well-structured contracts in place that make difficult conversations about passing on inflationary costs easier. Ideally, contracts are structured with adjustments for inflation and pass-through of essential input costs such as fuel. **Aurizon** (ASX:AZJ) benefits from such contractual protections. Here are some good examples of these types of companies, which also pay high dividend yields, and are currently trading at reasonable valuations:

Company	FY24 price to earnings (PE) ratio	FY24 dividend yield (%)
Aurizon	12.3x	7.3%
Metcash	11.9x	5.9%
Orica	16.1x	3.4%
Suncorp	12.1x	6.8%

Source: IML and Factset estimates, 14 December 2022

Finally, it's worth bearing in mind the types of companies that benefit directly from rising rates. Good examples right now are **Suncorp** through its investment earnings and **Aurizon** through the return determined by the regulator on its regulated asset base.

Michael O'Neill is a Portfolio Manager at Australian equities fund manager Investors Mutual Limited. This information is general in nature and has been prepared without taking account of your objectives, financial situation or needs. The fact that shares in a particular company may have been mentioned should not be interpreted as a recommendation to buy, sell, or hold that stock. Past performance is not a reliable indicator of future performance.

Retail investors aren't buying the dip

Gemma Dale

One of the joys of managing your own investments is that you don't suffer the constraints that professional investors have to deal with. As a do-it-yourself investor, your only major constraints are time and cashflow. Professional investors may have more sophisticated tools and resources, but they primarily invest within a specified universe and are benchmarked monthly, quarterly and annually against their peers. As a DIY investor, you can invest in whatever you choose, and the only benchmarks that matter are your personal goals and objectives.

We saw that retail investors stayed focused on their personal objectives in 2022. The clearest signal that investors were not going to chase returns in an increasingly challenging environment is the steady increase in cash held by investors from late 2021, through to now. nabtrade's cash allocation is currently at a record high, and grew throughout 2022, except for small outflows in June when the ASX200 bottomed, and investors took the opportunity to top up preferred holdings. This contrasts with 2020, when Covid's impact became apparent – cash outflows peaked as investors took advantage of dramatic falls in share prices across the ASX and global markets more broadly.

Cash has a new meaning in 2023

Retirees, who have struggled to generate income from their portfolios without moving up the risk spectrum over the last decade, can return to defensive assets should they wish. For most nabtrade investors, cash is a hedge against a downturn, and a holding account, should one or more share bargains present themselves. Clearly most investors are not seeing sufficient value in the sharemarket to reduce their hedge.

The last 12 months has seen a significant shift in focus from bargain hunting in 2020, when buys accounted for 80% of all trades placed on nabtrade from March to June, to wealth accumulation in 2021, to wealth preservation in 2022. The proportion of buy trades has fallen steadily as the market climbed through 2021, and then wobbled through 2022. One would expect to see more buying than selling over time, as investors are growing their wealth (and retirees generally attempt to preserve, rather than draw down, their capital), so even short-term increases in selling tend to indicate genuine concern about the future direction of share prices.

Trading volumes down

Another indicator of investor caution is a significant fall in trade volumes over 2022. As the year ended, volumes were roughly half, on average, the most traded days of 2020. Given that total investor numbers have doubled since pre-Covid, this is quite telling. A fall in volume doesn’t necessarily indicate bearishness, but it clearly indicates that investors are not seeing a great deal of value on the sharemarket and are not going to chase returns. Any pullback on the ASX has been relatively modest compared with the Covid crash, and investors are no longer excited about ‘buying the dip’ when a rising interest rate environment has increased headwinds for equities. With cash accounts paying 3% or more, the potential downside risk in sharemarkets is far less palatable than it was when rates were close to zero.

In addition to lower trading volumes, different types of investors are responding differently to this market. While most new nabtrade investors over the last two years have been buying ETFs to hold for the long term, not trading their cash away on YOLO stonks as popularised in the US, these young investors stayed on the sidelines in 2022. They are generally still holding their Covid share purchases, but are less likely to trade than older, more experienced investors who are continuing to find opportunity despite the volatility. Interestingly, some of our most active and sophisticated traders are more active than ever, but this seems a market that favours experience over enthusiasm.

Materials and energy popular

The range of stocks traded in 2022 narrowed significantly relative to previous years and focused on just two sectors – materials and energy. Fortescue Metals Group ([FMG]) remains extremely popular with traders as a pure iron ore play, while BHP ([BHP]) is simply too big to ignore.

Source: Morningstar

Beyond these two, however, the battery metals sector was the big favourite for traders and investors. Lithium producers and hopefuls featured heavily in the top 10 traded stocks throughout the year, with Pilbara Minerals ([PLS]), Core Lithium ([CXO]) and Allkem ([AKE]) the most favoured. These have the advantage of being liquid enough to attract the attention of traders, and at the forefront of a long-term trend in decarbonisation for investors, although the trade sizes remain modest, suggesting this sector is not a core holding for most – just some fun money.

The price action and excitement in the materials space have crowded out other sectors that would generally feature heavily. The most consistent buy of the year was exchange traded funds (ETFs), with Vanguard's Australian Share Fund (**VAS**) by far the most popular. Investors have learned to watch daily price movements in the US and take their leads from the futures market, as buying spikes dramatically when the ASX is sold off and falls away on strong days. For accumulators, this is a clearly a long-term wealth creation strategy; most of these investors are young, do not actively trade their holdings and focus on one or two specific ETFs to build their portfolio.

Reluctance to increase bank holdings

Financials are always popular as income-focussed investors appreciate the relatively stable fully franked yields of the big four, but as most investors bought banks aggressively during the Covid crash, many are reluctant to add more to their holdings. Of the big four, Commonwealth Bank (**CBA**) is the second largest holding, and frequently trimmed above $104, while NAB (**NAB**), by far nabtrade investors' largest holding, was trimmed above $31 and bought below $30. Westpac (**WBC**) has been the most popular bank buy over the last 18 months as investors hope for a resurgence that is yet to eventuate, but overall bank volumes are well below average.

Source: Morningstar

Those investors who remained active in 2022 were happy to take profits in sectors that have outperformed, with energy being the most obvious example, but less enthusiastic to rotate into sectors that have underperformed. There was a total lack of interest in fallen angels – stocks like Magellan Financial Group (**MFG**), which fell more than 70% over twelve months, and Zip Co (**ZIP**), down more than 80%, found few buyers, and even saw sellers as investors come to terms with the likelihood that they will never return to their highs.

Overall, nabtrade investors appear to have focused on preserving their capital in 2022 and remain cautious about the outlook in 2023. The flexibility of being able to go to cash when desired and rotate in and out of sectors offering different outlooks, has given investors the opportunity to consolidate and even capitalise in a period of heightened volatility.

Gemma Dale is Director of SMSF and Investor Behaviour at nabtrade, a sponsor of Firstlinks. Stock charts as at 30 December 2022. This material has been prepared as general information only, without reference to your objectives, financial situation or needs. For more articles and papers from nabtrade, please click here.

Why investment grade credit looks attractive

Bruce Murphy and colleagues

With inflation accelerating well beyond initial expectations and proving persistently elevated, central banks embarked on an aggressive tightening cycle through 2022, driving global rates upwards.

Markets are now caught between still hawkish central bank rhetoric and perceptions that economic data is starting to meaningfully soften. After experiencing the first bond bear market in a generation, many investors are desperately seeking justification for a dovish shift at global central banks that will act as a catalyst for a rally in bond markets.

In the US, markets are so convinced of the Fed's inability to maintain tighter monetary policy that rate cuts are being priced in for 2023. This contrasts with the Fed's own forecasts that rates will not fall until 2024 (see Figure 1).

In our view, markets are likely to be disappointed. Although inflation has likely peaked in the short term, and could moderate rapidly in the months ahead, it is unlikely to return to the Fed's target for a considerable period.

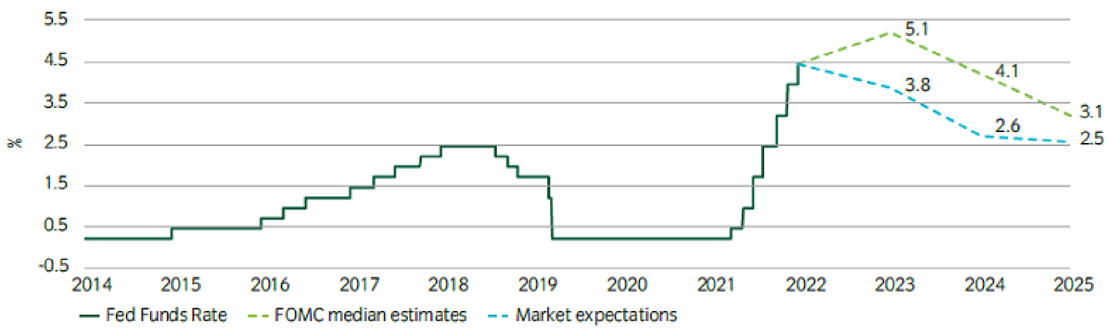
A similar situation can be found across Europe, with European Central Bank President Lagarde warning that "recession alone won't tame inflation" and the Bank of England highlighting that professional forecasters still expect UK inflation to be above target in three years' time.

TINA no more: there is a realistic alternative

A consequence of the upwards adjustment in interest rates is that investors now have a realistic alternative to generate returns without having to resort to higher risk assets or sacrificing liquidity to add incremental yield. The acronym TINA (there is no alternative), justifying a shift to riskier assets, became embedded in investor psychology following the global financial crisis and the low-yield environment that followed.

It may take time for markets to readjust to a world where lower-risk assets provide meaningful returns, but as they do, flows should follow. A gradual reallocation from higher risk to lower risk assets in the years ahead should help to counterbalance central bank sales and anchor longer-term yields.

Figure 1: Markets are already pricing in US rate cuts in 2023[1]



[1] Source: Federal Reserve, Bloomberg, December 2022

Global Inflation peaking but likely to prove sticky

The elevated inflationary pressures that dominated 2022 should wane in 2023. Goods prices, which were key to the initial acceleration in prices, should lose momentum as supply chains normalise (see Figure 2). The global chip shortage, which caused huge problems for the auto industry and various high-tech industries, appears to have come to an end, with inventories rebuilding rapidly. Global shipping costs are also trending downwards, a relief for global supply chains reliant on cheap imports from Asia. Rising commodity prices could return as a future inflationary impulse, but further upside is likely to be tempered by growth concerns, and even a sideways trend in prices would have a significant impact on inflation due to base effects.

Although this should take some pressure off major central banks, the longer-term outlook remains concerning. Labour markets are tight, and wage pressures are unlikely to dissipate until workers have recovered real spending power. Economies now dominated by services are experiencing the highest levels of service inflation for decades (see Figure 3), and this may prove more difficult to tame. Globalisation, a structural force that has acted to keep inflation low for decades, is also unlikely to play such a significant role in the years ahead. The pandemic highlighted the vulnerabilities of global supply chains, and corporates are searching for ways to return production closer to home.

These factors make the medium-term outlook more challenging and, although the highest year-on-year rates of inflation may be behind us, inflation is likely to remain stubbornly sticky above central bank targets for a considerable period to come.

Figure 2: Supply change pressures are fading away[2]

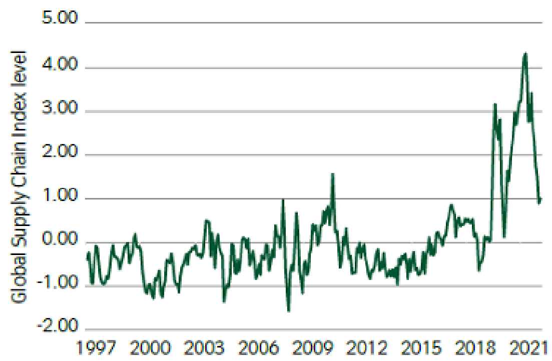
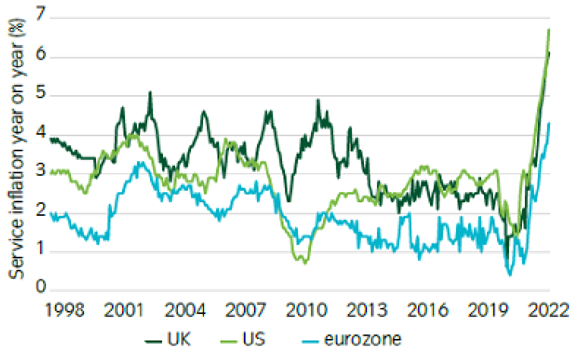


Figure 3: Goods prices may have peaked, but service inflation pressures remain[3]



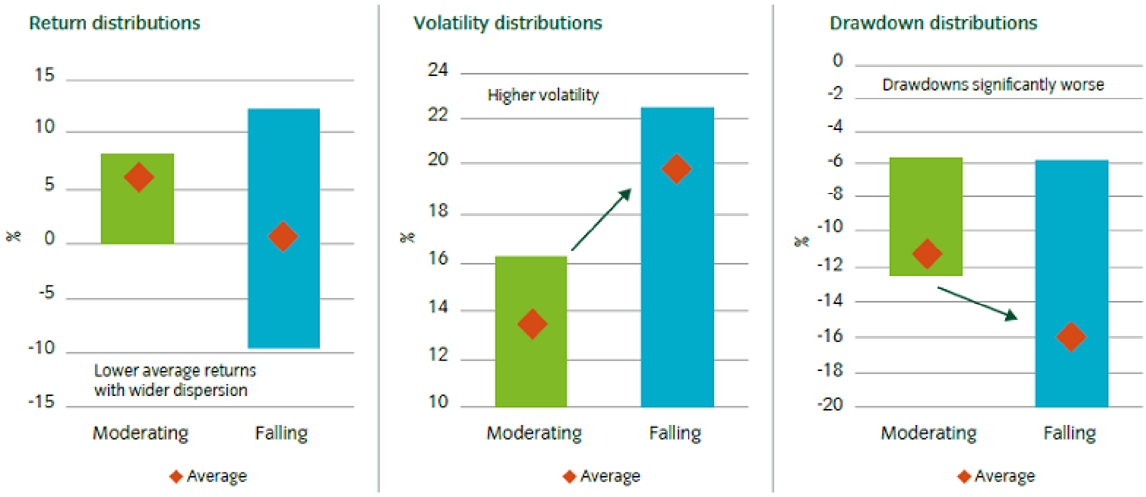
[2] Source: Bloomberg, Federal Reserve Bank of New York Global Supply Chain Pressure Index, October 2022.
[3] Source: Bloomberg, October 2022.

Asset allocation for the new environment

In some parts of the world (eurozone and the UK), a recession is all but inevitable, but growth dynamics in most countries are likely to be challenged in the pursuit of getting inflation closer to central bank targets. Our own assessment of the cycle considers a broad range of factors. We often refer to purchasing managers indices (PMIs) as they provide a timely set of comparable data points across countries and regions. Our assessment of them, and other forward-looking indicators, suggest we entered a phase where economic activity has been contracting from the summer of 2022.

We have a rich set of data that allows us to look at historical asset class behaviour in various combinations of growth, inflation, and real interest rates. Using history as a guide, average asset class returns are not dissimilar whether we look at regimes where economic activity is moderating or contracting. However, volatility tends to be higher for risky assets in contractionary periods and draw-down risk is much more elevated (see Figure 4) and this was evident in Q3 2022.

Figure 4: A comparison of equity returns in moderating and contractionary growth regimes[4]



[4] Source: Insight and Bloomberg, data between March 1976 and October 2022. Growth regimes are measured based on changes in PMIs. Moderating regimes are when PMIs are above 50 but declining, falling regimes are when PMIs are below 50 and declining.

Cautious for now, but with an eye on the turning point

A contractionary growth regime would indicate that a defensive bias is warranted as long as a combination of stubbornly high inflation and the increasing prospect of slower growth paints a challenging environment for most traditional assets. However, it is also notable that the outlook is now well known to most market participants and market sentiment is hovering at levels of extreme pessimism.

Such environments can see brutal upward corrections, and the ability to access a range of alternative investments such as option-based strategies can be helpful both from a risk mitigation and return generation perspective. At some point in 2023, conditions may become more constructive and when we consider the factors that normally correspond with bear market recoveries (see Figure 5) they remind us that we do not have to wait for growth (or corporate profits) to bottom before markets can look forward to recovery.

Figure 5: Bear market recovery – checklist[5]

NORMAL CONDITIONS FOR A BEAR MARKET BOTTOM

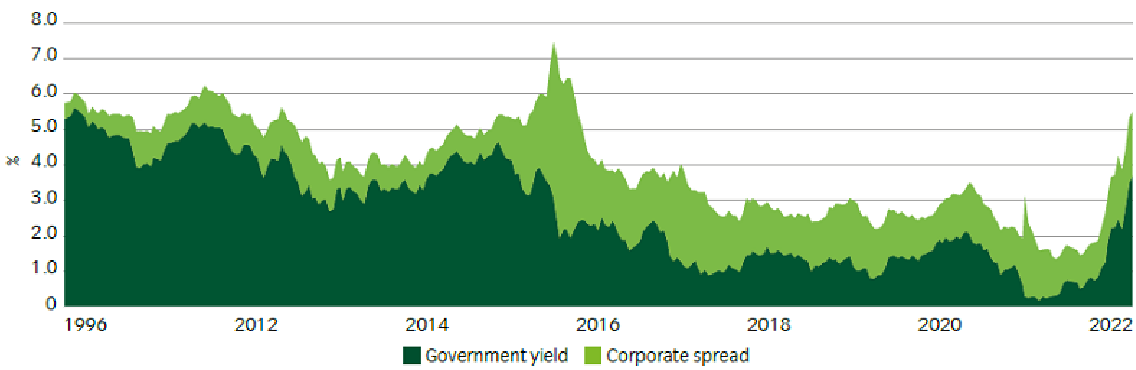
1. Rate expectations decline
2. Bond yields begin to rally
3. Inflation peaking
4. Growth bottoming
5. EPS down (stocks rally when EPS is still falling)
6. Capitulation

[5] Source: Insight, for illustrative purposes.

The return of attractive long-term income-based returns

A combination of rising government bond yields and widening credit spreads created a perfect storm for credit investors over 2022, driving absolute yields back to levels like those seen before the global financial crisis (see Figure 6) and spreads to historically attractive levels (see Figure 7). Investment grade credit now potentially offers a way to achieve long-term return objectives via income alone, without the drawdown risk inherent in equity markets.

Figure 6: Absolute yields are back at levels where meaningful income returns can be generated[6]



[6] Source: Insight, Bloomberg and Bank of America, October 2022. Global investment grade universe represented by ICE BAML Global Corporate index (G0BC).

Despite the rise in yields, many corporate issuers are insulated from the interest rate shock. Through the period of low rates, corporates gradually extended their bond maturity profiles, taking advantage of buoyant market conditions to lock in low funding costs. As this debt gradually approaches maturity, funding costs will creep upwards, but for many issuers it will be years before this has a meaningful impact, with close to 45% of companies having an average debt maturity of 10-years or longer (see Figure 8).

Figure 7: Valuations historically attractive[7]

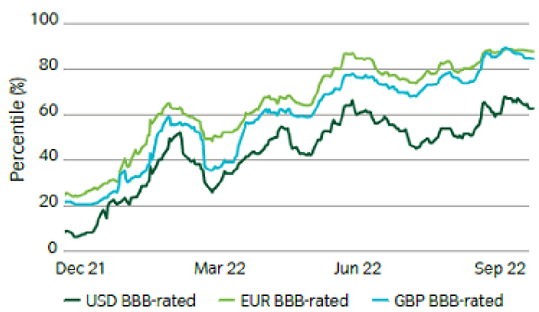
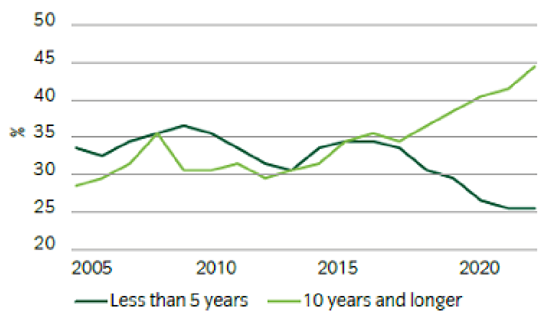


Figure 8: Companies have lengthened their debt profiles[8]



[7] Source: Insight, Bloomberg and Bank of America, October 2022, percentiles are for data between March 2001 and October 2022. 100% is highest spread in series, 0% lowest spread in series. [8] Source: Insight and Bloomberg, September 2022.

For those best able to pass rising costs onto their customers, the combination of high inflation and long maturity fixed rate debt will potentially allow debts to be inflated away over time, effectively allowing some issuers to naturally deleverage. Until there is greater confidence that inflation is under control and that the growth outlook has stabilised, the risk of further volatility persists – making it hard to predict a rally in spreads. But, for those investors able to hold for the longer term, return objectives may now be achievable with income alone.

Bruce Murphy, Director, Australia and New Zealand, [Insight Investment](#)
Gareth Colesmith, Head of Global Rates and Macro Research, [Insight Investment](#)
Matthew Merritt, Head of Multi-Asset Strategy Group, [Insight Investment](#)
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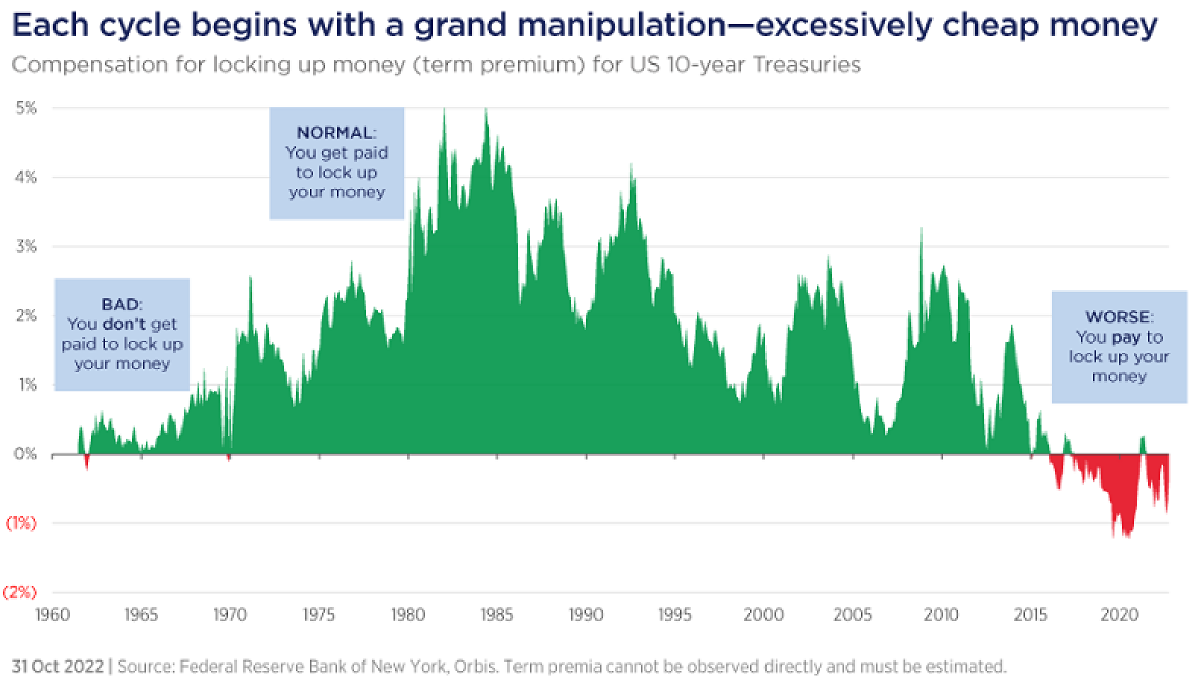
Download the [full report here](#).

What to do about our distorted relationship with money

Shane Woldendorp

There is no logical reason this chart should ever go into negative territory. That it has is a clear indication that the market's relationship with money has become distorted and has been for a long time.



What is a term premium?

This is the compensation you get for agreeing to lock up your money, for taking on 'time risk'. The longer you lock your money away, the more time there is for unexpected things to go wrong and the more of a 'premium' or added incentive you should be paid to make it worth your while.

In a normal economic environment, you should get paid more to hold a bond that matures in 10 years than you do to hold 10 one-year bonds, for example, because you're taking on that extra risk.

Currently, as the chart shows, investors must pay for the privilege of locking up their money for 10 years in US government bonds.

This suggests that investors don't think any premium is required; that essentially money today is no more valuable than money tomorrow, or next year or in the next decade and as a result they aren't demanding extra rewards to offset that long-term uncertainty.

This extremely loose money, or negative term premium, environment has tended to favour growth stocks because investors have to defer their rewards, eschewing profits now in the hope of significant growth in the future. A decision that seems sound when there is an expectation that the future holds no additional risks and the alternatives are established, boring (albeit cash-generative) businesses that aren't likely to grow dramatically from where they are today.

Has this ever happened before?

As the chart shows, the term premium has recorded lows before, particularly in the 1960-70s and the late 1990s-early 2000s. Those two periods were similar to what we're seeing today, where there were loose money environments that coincided with very frothy market conditions that created a bubble.

Although the term premium did not fall into negative territory, as we're witnessing now, these extremely loose money environments led to underinvestment by 'real economy' businesses, those that make or produce actual things, like energy, paper or cement, while more capital made its way towards 'new' economy businesses such as technology.

This cycle of underinvestment in the 'real economy' led to lower supply, which led to higher prices, which led to higher inflation.

A similar environment is evident today, as seen by the current energy supply shortages. But we're facing even greater challenges than previous periods given that we have the added burden of external factors such as transitioning to clean energy to reduce CO_2 emissions.

What happens next?

The good news is these cycles eventually unwind, but this can take a long time. For example, on the energy side, it took around 8-12 years in the 1970s to rebuild production and alleviate shortages.

Until that happens, those shortages remain inflationary as low supply and high demand will push prices higher, which in turn drives inflation. Luckily, this metric is a key focus for most central banks and to try and curb inflation rises they will look to tighten the money supply – usually through higher interest rates. This in turn will lead to a more rational term premium as people will start to value money today more highly, leading to a focus on more essential items and capital being allocated more efficiently in the real economy.

What does this mean for investors?

A tighter policy stance from central banks will be negative for asset prices, which means general stock market returns might disappoint. That means stock selection becomes critical.

Currently there is a significant gap between the value and growth stocks in the market. This is because in a loose money environment valuations become dispersed along specific lines and in each of the periods we've discussed, this fracture in the market has been between 'old economy' and 'new economy' businesses.

The willingness of investors to focus on the slim chance of a big future payoff rather than money today, can drive speculative capital into new economy or growth assets that then see the share price rise and their ability to invest in new projects increase. Meanwhile, the reverse is true for businesses whose share prices have been left in the dust, for example, these old economy, lower growth companies. A low share price means they have little incentive to invest in new projects, which affects production and supply.

However, as the term premium returns to normal leading to better rewards for taking on longer-term risk, the situation above should reverse which should see the extreme valuation gap between the value and growth stocks starting to close.

In this type of environment, it's therefore important that investors understand what a business is worth and what you should pay for it in order to generate satisfactory returns and avoid overpaying for a stock.

This tends to bode well for active stock selection, and more so for value driven investors who can take advantage of this mispricing as they are more focused on the underlying value and fundamentals of a business.

Shane Woldendorp, Investment Specialist, [Orbis Investments](), a sponsor of Firstlinks. This report contains general information only and not personal financial or investment advice. It does not take into account the specific investment objectives, financial situation or individual needs of any particular person. For more articles and papers from Orbis, please [click here]().

Active or passive – it's time to change the narrative

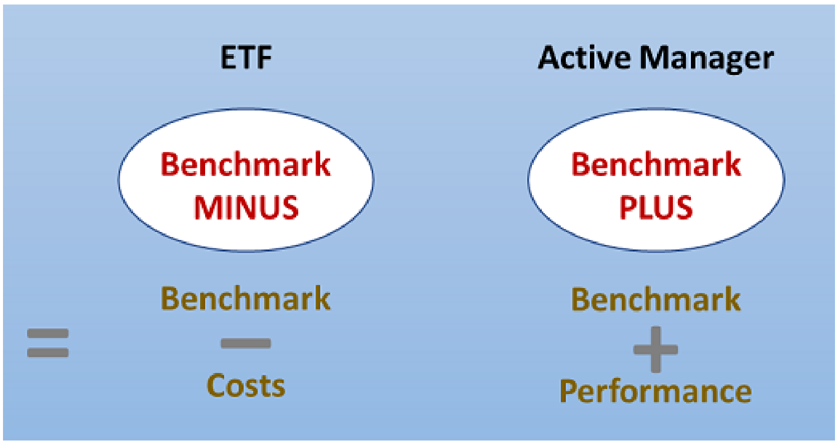
Romano Sala Tenna

The question around active versus passive managers is subtly but critically predicated on the lazy assumption that it is not possible to consistently choose managers that consistently outperform. By extrapolation, if you cannot choose managers that consistently outperform, then you should settle on passive managers which at least won't extort as much for the privilege of making less than the benchmark.

But both the premise and (hence) the narrative are fundamentally flawed.

Re-cap passive versus active

A passive investment such as an Exchange Traded Fund (ETF) is a reasonable starting point to commence the investing journey. It generally charges low fees, is professionally administered, and employs a strong level of corporate governance and oversight. ETFs can also provide a good way to gain exposure to offshore companies and specific thematics.



For these reasons, passive investments provide a good starting point for retail, inexperienced and non-professional investors.

But there are some limitations. To begin with, ETFs cannot replicate an accumulation index to achieve proper compounding as there are too many moving parts. An ETF still charges management and administration fees. And most importantly, an ETF aims to perform in line with an index – not out-perform the index. And it is this last point which is most critical in the context of long-term wealth accumulation.

Re-cap on compounding

If you have followed Katana for a while, you will know of our obsession with investor education, data and the power of compounding. To re-cap a simple but particularly pertinent example, consider the effect of time on long term equity returns.

Over the past 146 years, the ASX has averaged 10.8% per annum when aggregating dividends and capital growth[1]. If an investor was to reinvest and compound their earnings each year, these returns would be magnified. And this increase accelerates with every passing year.

For example, after 10 years of compounding, the returns would be equal to 17 years. If the investor was to compound for an extra 5 years, it would double this to be the equivalent of 34 single-year returns. And adding just another 5 years, would double it again, such that compounding for 20 years would produce the equivalent of 63 one-year returns. This accelerates even further with time.

Timeframe (rolling average)	Average return since 1875	Times one-year returns
10 years	179%	17x
15 years	366%	34x
20 years	678%	63x

Source: Katana Asset Management[1]

Why active returns are critical

As impressive as this is, let's now consider the impact that a good active manager can have through time and compounding. By way of example, we have assumed that an active manager has out-performed by 2.7% per annum net of all fees (Katana has out-performed by ~3% per annum net of all fees for 17 years; please note past performance is no guarantee of future performance).

The extra 2.7% per annum when compounded over time produces extraordinary returns. After 10 years, the active management returns would be the equivalent of 24 years versus 17 years for the index. Over 15 years this would have grown to 53 years equivalent one-year returns versus 34 years for the index. And rather incredulously, if an investor was able to achieve an extra 2.7% per annum for 20 years, this would equate to the equivalent of 107 one-year returns versus 63 one-year returns for the index.

Timeframe (rolling average)	Average return since 1875	Times one-year returns	Extra 2.7% per annum	Times one-year returns (KAEF)
10 years	179%	17x	255%	24x
15 years	366%	34x	568%	53x
20 years	678%	63x	1,159%	107x

Source: Katana Asset Management[1]

[1] Note past performance is no guarantee of future performance. Dividends have averaged 4.54% per annum since Accumulation Index commenced in 1979; assumed at 4.5% per annum prior to that.

This cannot be ignored.

Good active managers do exist and can out-perform over the medium and longer term. And good active managers do have consistent characteristics that can be identified and assessed. This is not to say it is easy, but it is possible. And ultimately that is what investors are paying advisers and consultants for. To generate performance that they could not otherwise generate themselves through passive strategies.

Over the past decade, better investor education and greater transparency of data has led much of the professional advice industry to think that it is too hard to deliver meaningful outperformance. There has almost been a quasi-resignation that it is too hard to generate sustained alpha, so therefore let's change the narrative to cost-conscious, passive investing.

But the returns above highlight why advisers are selling short those who rely on them. Morally and financially, advisers owe it to investors to get better. Not to settle for less.

Conclusion

Through the power of compounding, it is evidently clear that the discussion of active versus passive is not really a question at all. What it really amounts to is the competence and capacity of advisers and asset consultants to select consistently good managers. The question should really be '*How do we select consistently good managers*' not '*is active or passive better'?* The impact that genuine and consistent out-performance has over time is too compelling to contemplate anything else for professional investors.

Romano Sala Tenna is Portfolio Manager at Katana Asset Management. This article is general information and does not consider the circumstances of any individual. Any person considering acting on information in this article should take financial advice.

Compelling investment opportunities in healthcare

Jeremy Gibson

Identifying and investing in the next big long-term structural growth trend is one way for investors to differentiate themselves in a competitive market.

Doing this is an integral part of our investing process at Munro Partners and we call these major growth trends areas of interests. Innovative health is one of Munro's key areas of interest and one that is developing and advancing rapidly.

Health offers fertile ground for innovation across areas like diagnostics and patient care, genetic sequencing, virtual reality, and surgical robots.

The COVID pandemic brought specific investment opportunities in vaccines and treatment, but innovative health has been on a structural growth trend for over a decade on the back of several key drivers.

The drivers of healthcare innovation

There is a lot going on in the global healthcare landscape and we believe the resulting investment opportunities from this structural change are shaped by the below three trends.

1. Demographic change

Demographic change is having a real impact on healthcare as populations age across the developed world. Life expectancy has improved dramatically over the past 30 years. A baby born in Australia in 2020 can now expect to live to 81.2 years for a boy and 85.3 years for a girl, whereas in 1990 the equivalent figures were 73.9 and 80.1 years respectively.

The Baby Boomers, with higher expectations around their standard of living, are now between 58 and 76 years old.

A consequence of living longer is that many people end up with chronic conditions that need to be managed. For example, 46% of Australians aged over 65 suffer from two or more chronic conditions, compared with just 11% of those aged 15-44. Nearly half of all Australians aged over 75 have arthritis, and one in five has osteoporosis.

Not only do we have more diseases or medical conditions, but we are also expecting better care when we have them and are often prepared to pay for this superior care.

These demographic changes mean that disease prevention, treatment, and lifestyle management for the older members of society is a massive and growing subsector of the healthcare industry.

2. New technologies

Technology is making headway in healthcare, and companies across the spectrum - from start-up biotech pioneers to global pharmaceutical giants - are inventing new products and processes to assist in diagnosing, treating or curing diseases. More efficient healthcare provision is also a focus.

Predictive analytics in the field of artificial intelligence is also helping hospitals to better manage patient volumes and staff-to-patient ratios. And in surgery, micro robotics are being used in surgical treatments previously considered dangerous and invasive.

Innovations in the fields of genomics and gene therapy techniques are also important. These advances could be the start of a new era of personalised medicine as opposed to old-style generic treatment plans for all patients with the same diagnosis.

All of these innovations are huge and not only do they help in improving the health of everyone on the planet, they also offer a range of potential opportunities for long-term growth investors.

3. The rising cost of healthcare

This brings us to cost. Early-stage innovation technology is rarely cheap, and global spending on health climbed to US$8.5 trillion in 2019, or 9.8% of global gross domestic product (GDP), according to the World Health Organisation.

Unsurprisingly, health spending per capita in high-income countries was more than four times higher than in low-income countries, with the US healthcare system alone accounting for 42% of total global health spending.

There are therefore investment opportunities available in products, processes and systems that can reduce the cost of healthcare.

Lessons from Covid

As the pandemic spread around the world, the race to develop a successful vaccine to inoculate as many as possible began. But rather than pick a winner, in terms of what companies might emerge with the winning vaccine formula, at Munro Partners we decided to focus on the supply chain. We researched a wealth of opportunities and ended up focussing on companies in the biologics ecosystem which were critical in the development of the next generation mRNA (messenger ribonucleic acid) vaccines.

Biologic drugs are unique in that they are developed from cell culture media or living organisms rather than via a chemical synthesising process. Because of this, biologic drugs can specifically target the disease they're designed to attack. This means they usually have a much higher efficacy and fewer side effects.

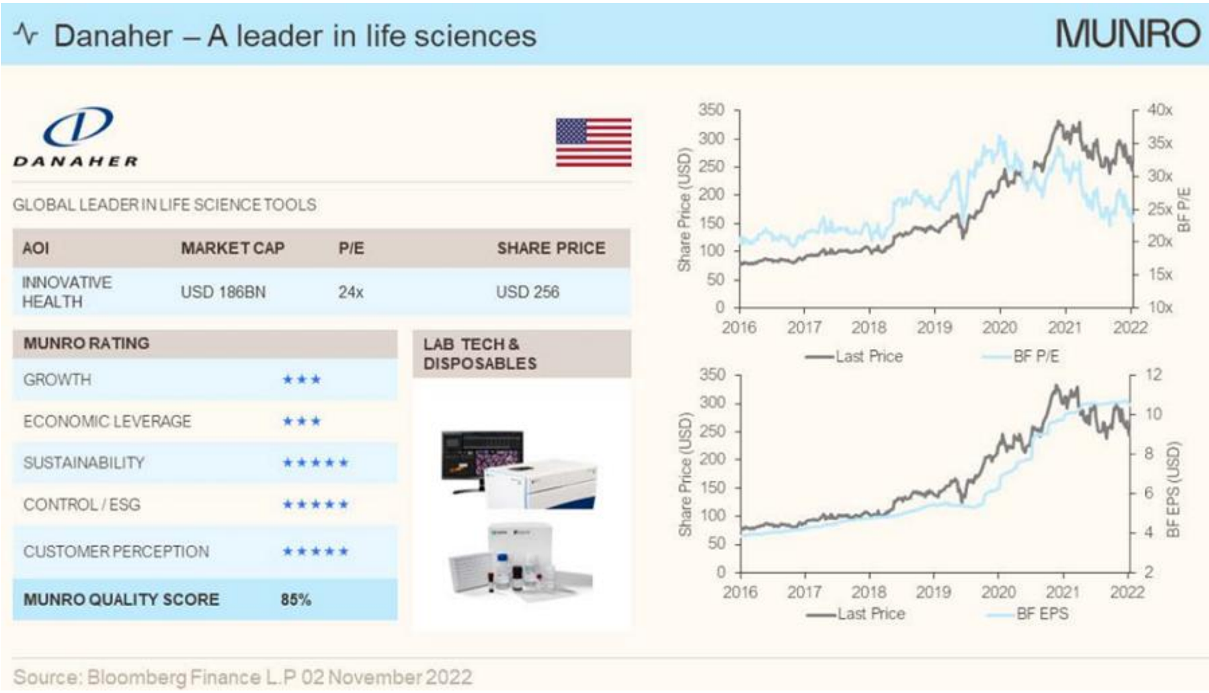
We looked to the supply chain for biologic drug companies and found investment opportunities in the companies supplying the consumable equipment needed by the vaccine producers, a strategy we saw as akin to investing in the picks and shovels that enabled the gold rush.

A stock story: Danaher Corporation

One such company is Danaher Corporation in the US. This is currently Munro's biggest position in innovative health and a company we were investing in long before Covid.

Danaher is a specialist in life science products, which make up over 50% of group profits, and is a major provider of the consumable products on which biologic drug developers rely. These products include filtration equipment and cell culture products, which provide a very high recurring revenue stream for the company. Danaher was also quick to develop Covid tests when the pandemic hit.

As biologic drugs take further market share from synthetically produced drugs, Danaher is in a good position to benefit. It has also made a number of strategic acquisitions including GE's bio-pharma business GE Healthcare Life Sciences, which it acquired in 2020 and renamed Cytivia. It is now a standalone operating company within Danaher's life sciences division.



To the future

In terms of innovative health, the long-term outlook will increasingly be about advances in cell and gene therapies, and genomics. Companies that supply those developing the vaccines and other therapies, like Danaher, are uniquely placed to benefit and where we see some of the biggest investment opportunities.

Jeremy Gibson is a partner and portfolio manager at [Munro Partners](). Munro is a specialist investment manager partner of GSFM Funds Management, a sponsor of Firstlinks. The information included in this article is provided for informational purposes only. Munro Partners do not represent that this information is accurate and complete, and it should not be relied upon as such. Any opinions expressed in this material reflect our judgment at this date, are subject to change and should not be relied upon as the basis of your investment decisions. For more articles and papers from GSFM and partners, click here.

The 1970s offer a helpful framework for today's markets

Mercer

The last 12 months have seen significant upheaval in global markets, with several notable events having a profound impact on the world as we know it. Pandemic restrictions are now in the past as most of the world has decided to 'live with Omicron', but we still feel their fallout in the elevated debt burden and fragility of the 'just in time' production model. At the same time, regional conflict has further exacerbated supply chain stresses and led to higher food and energy prices.

Elements of these experiences echo those of the 1970s — another period that started with the aftermath of a severe virus (influenza strain H3N2, 'Hong Kong flu') and conflict-induced shocks in the energy complex (Nixon's support of Israel in the Yom Kippur War causing a swift and lasting retaliation from OPEC). Some parallels are concrete, whereas others are uncanny. Both pandemics led to the hospitalization of premiers called Johnson, and the series of Apollo missions at the time has now been replaced by a series of missions back to the moon named after Apollo's sister Artemis.

Investors then, as now, faced the challenge of investing during a period of inflation, cold war, and decoupling, which leaves us with a sense of déjà vu. Yet we are not in precisely the same place.

The current challenge in prices is happening at the same time as a wider sustainability crisis (accelerating physical damages from climate change and biodiversity on the brink). But we are in a better place to find solutions to the crisis, with renewable technologies having gained the critical mass they did not have in the 1970s. Although the respective decades are not in identical situations, distinct parallels can be drawn. Combined with the increased potential for change, these parallels can best be encapsulated by the concept of Déjà New.

The inflation playbook

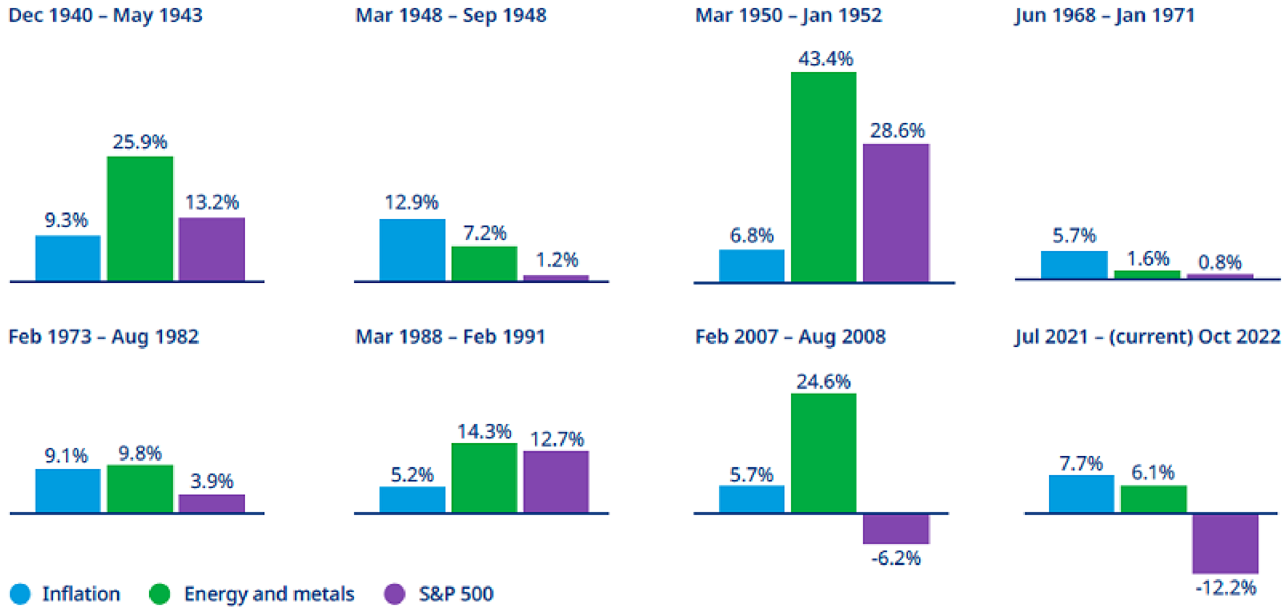
Inflation has been one of the driving themes and concerns for investors over the past 12 months. Even if many believe inflation is beginning to slow, it is unclear how long it will take to return to a level that resembles central bank targets. Several factors suggest that the challenges of the current inflation bout are far from over and that inflation risk has increased in the long term:

- Globalization is likely slowing and moving toward factionalization.
- Policymakers may be tempted to keep interest rates lower than inflation to reduce the debt burden over time, at the risk of runaway inflation.
- Significant challenges exist with respect to energy infrastructure, security and electrification, particularly in Europe.
- Price increases because of higher wages (the so-called wage-price spiral) could continue, although union power has declined significantly since the 1970s.
- Trends in the pricing of consumer electronics and improvements in storage and processing power appear to have been flattening out, although AI and quantum computing could eventually pull prices down. (The 'tech deflator' has been a long-term anchor for inflation.)

All of this points to the need to structure portfolios for inflation regime management, not just business cycle management, and it is here that elements of the lessons of the 1970s and other periods can be employed. The shift from building in 'shock protection' (in response to short-term price movements) to assets targeting longer-term inflation-sensitive revenues may be a sensible rule of thumb for investors to consider. Natural resource stocks provide such revenues, and — despite the performance of underlying commodities — are still arguably under-loved given underserved global energy and materials demand.

In the 1970s, the issuance of inflation-linked bonds was mainly limited to emerging markets, whereas the UK started issuing index-linked gilts in the 1980s, and the US Treasury started issuing Treasury Inflation Protected Securities (TIPS) in 1997. With real yields now positive in some major territories despite higher inflation and yield curves priced for inflation to fall back again, inflation-linked bonds may offer better protection than nominal bonds against persistent inflation.

Figure 1. Natural resource equity returns through periods of high US inflation



Source: GMO and Mercer; periods where US inflation was over 5% for longer than a year. "Inflation" and "energy and metals" are industry classifications, constructed by GMO. Data for energy and metals in the most recent period is from the MSCI ACWI Commodity Producers Index. All returns in USD.

The end of 'free money'

A consensus is that the era of 'free money' and ultra-loose central bank policy is at an end. The US Federal Reserve has acted on its plans to raise interest rates to reduce unacceptably high levels of inflation; indeed, the minutes from its September 2022 meeting emphasize that "the cost of taking too little action to bring down inflation is likely to outweigh the cost of taking too much action." Similarly, other major central banks have taken firm policy approaches. (the exceptions being China and Japan).

Despite this, even the rate rise in late 2022 leaves rates far below the Taylor Rule — a rule of thumb proposed by Stanford economist John Taylor in 1993 as to where we can expect central bank rates to be given current inflation and unemployment levels. Therefore, more tightening has been priced in across a number of asset classes, with real yields now higher in many cases than nominal yields were a year ago and high-yield debt assets now living up to their name.

With higher rates and cheaper equity and bond valuations, investors might be tempted to think there is a stronger case for the traditional 60/40 portfolio; however, reliance on such a strategy is risky, particularly because equities and bonds may be positively correlated during an inflationary environment. Uncertainty remains, and an important concern now should be the potential for monetary and fiscal policies that grate against each other. On one side, central banks are seeking to rein in inflation, whereas on the other side, governments are fuelling inflation through fiscal expansion, seeking to mitigate real wage crunches, securing electoral support and/or seeking to fund transition-oriented infrastructure build-outs.

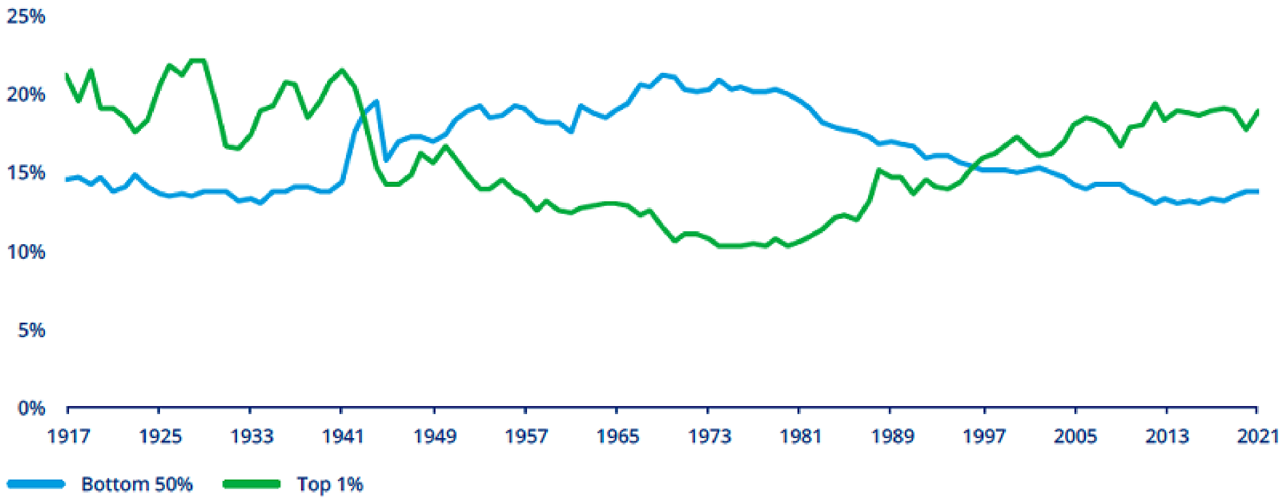
Balance of power

The parallels with history — specifically the 1970s — can also be applied to current geopolitical and social dynamics. In 1973, US President Richard Nixon proposed providing military aid to Israel during the Yom Kippur War. The result was an Arab oil embargo that forced the Western world to economize for the subsequent decade. Admittedly, several positive developments came on the back of this, with the birth of many renewable technologies, energy-demand-reduction technologies and supporting policies to address the challenges posed by the embargo. Today, there are similarities to that dynamic, with the Russia–Ukraine conflict impacting supply chains and forcing Western countries to consider much-needed evolutions to energy provision and infrastructure.

Alongside this, we are seeing a move away from globalization toward factionalization, with the current Russia–Ukraine conflict and reactions to it drawing dividing lines between nations and regions. This raises the question of whether we will see future conflicts, with a potential Taiwan conflict already a major concern, while score-settling may spread to other regions as hegemons are preoccupied and overstretched. More broadly, factionalization has implications for the powerful deflationary force that unconstrained globalization has had since the start of the century.

Other threats to the balance of power as we know it are the trends of dissatisfaction and inequality that we're seeing within society. Inequality is now at pre-World War II levels, with 14% of income flowing to the bottom 50% of society, while 19% goes to the top 1% (see Figure 2).

Figure 2. Income inequality in the US



Source: World Inequality Database, Mercer. Data as of December 31, 2021.

Global unhappiness (measured by Gallup's Negative Experience Index) has also been on the rise. These levels of dissatisfaction are potentially related to polarization over economic and cultural issues. At best, this polarization can increase the risk of unconstructive politics or novice governments and, at worst, increase the risk of internal and/or external conflict. With little immediate prospect of these trends reversing, investors should be prepared for more volatility, driven by political and geopolitical events and more uncertainty in general.

This is an extract from Mercer's paper, "Themes and Opportunities 2023: Déjà New, from hindsight to foresight". Download the full report or listen to the podcast to learn more about the three key themes which we believe will better position investors for success in 2023 and beyond.

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