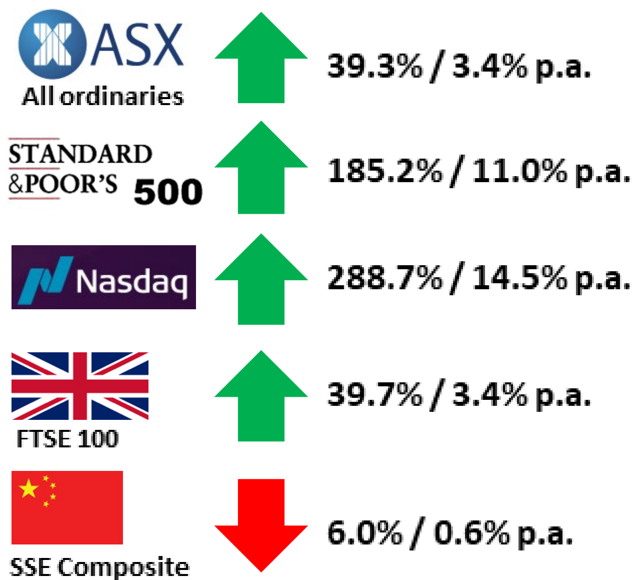
Alvia Asset Partners Investment Team Insights

December 2019 Quarter

General Commentary

The decade that was!



01/01/2010 - 31/12/2019 – Yahoo Finance

2019 was a big year for equities – locally, the All Ordinaries Index increased by 21% while internationally the S&P 500 rose 29%, NASDAQ +35%, FTSE 100 +12% and Shanghai Composite +24%. The major outlier was the UK FTSE index due to uncertainty around the country's exit from the EU. So, all in all it was a very strong year.

Now, reflecting on the decade that was – the 2010's. During the early stages of the 2010's, markets were climbing the wall of worry with confidence at record low levels as markets and economies emerged from the Global Financial Crisis of 2008 and 2009. Fast forward to the end of 2019 and investor sentiment has certainly changed, so too have interest rates and asset prices! The above performance numbers really highlight the importance of reducing the **"home bias"** to Australian equities – US equities have had an absolutely cracking 10 years.

During this time, the RBA cash rate was reduced from 3.75% to 0.75%, while the US Federal Funds rate has actually increased from 0.11% to 1.55%. It was a fairly big decade in residential property with Sydney prices up 49%, New York up 46%, London up 73% and Hong Kong up 197% (all in local currency terms). In commodities, gold increased 37%, oil fell 24% and iron ore fell 21%.

It's truly hard to believe that the 2010s have come and gone. If we look back to just before the turn of the decade in 2009, the world was in the depths of the Global Financial Crisis, locally companies including Babcock & Brown, Allco Finance and many others went to the wall, whilst those that survived on the ASX raised a record $70 billion from investors to shore up their shaky balance sheets.

Disruption of the 2010's – what's in store for the 2020's?

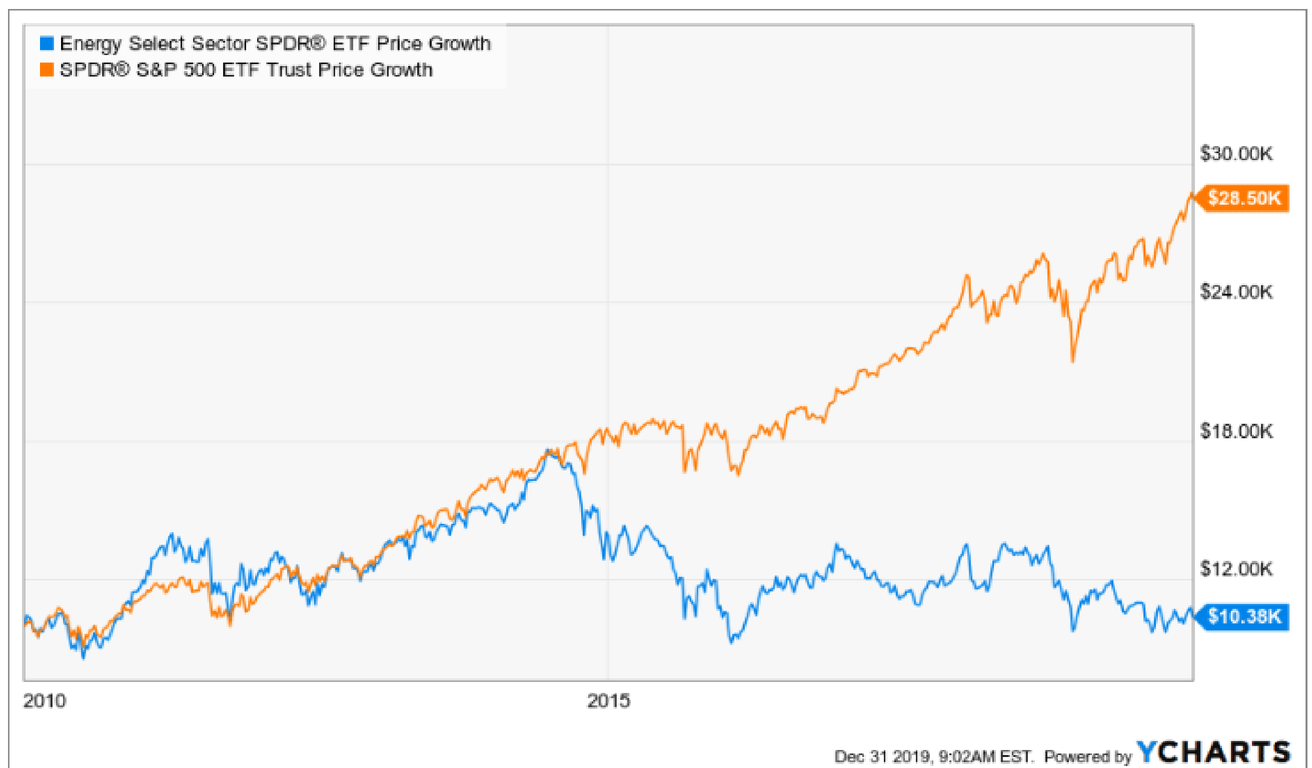
There were lots of big changes to our lives: think iPhone, etc. But there was a really big **under the radar** disruptor being the shale energy/un-conventional oil boom.

Fueled by low interest rates (again) this boom fundamentally altered the entire oil and gas supply dynamic and turned the US into the largest exporter in the world. This additional supply has applied significant pressure on the Middle East and Russia and clearly exaggerated tensions across the political spectrum.

Corporate wealth has transferred on the back of cheaper oil inputs (increased supply) and the largest companies across the globe are no longer underpinned by oil production but by the attraction of human eyeballs and their consumption preferences.

Look no further than Saudi Arabia which is currently scrambling to modernise and diversify by selling shares in its national oil company Aramco – this shift is meaningful.

Being long energy has clearly been the losing side of the trade!



Source: Reformed broker

The growing ESG theme in the 2010's going into the 2020's

The hidden C and the ESG dilemma

In our view, with the increased attention on ESG investing it's important to highlight other elements of responsible corporate governance that at times get discounted.

Within the 'G' for governance its super important to highlight two elements that in our view are most important and perhaps don't get the coverage they deserve.

These being a long-term mindset and a values-led culture. It tends to be with hindsight that we learn the importance of a positive corporate culture where a board administers a transparent strategy where the long term is the focal point and the short termism of Wall Street is disregarded.
Boeing provides a perfect case study in the inverse – a short term profit fixation and a corporate culture that promoted dictatorship-based leadership to the demise of an employee ground up diverse value-based thinking.

At Boeing, the Chairman and CEO were clearly focused on the immediate quarterly results with the view of focusing on the now and worrying about the future later. This culture permeated and as expected ensued short cuts and band aid solutions to adaptive long-term problems that really required ground up deeper thinking. Cost cutting conversations dominated the airway and engineering excellence (Boeing's brand promise) lost priority.

This short-term fixation worked for a while, however clearly exposed the business to long term problems – more and more stories began to emerge from the inner sanctum that highlighted a leadership profile that put short term profits before all else. More and more internal memos made their way to the board but were disregarded. All of which pointed to a toxic culture that had become fixated on profit over quality. One of which sadly suggested that an engineer would not put his own family on a 737 MAX.

Culture and long-term thinking matter in a world fixated on instant gratification. The G of ESG is broad, deep and subjective.

Reflection of the Decade

1. Amazon miss

A decade provides a great opportunity to look back on big opportunity cost misses – Amazon is the obvious big one.

Should we have seen it?

It's really hard to say in hindsight but the narrative if you looked closely surely presented a solid long-term capital mindset which we love. It's just the traditional fundamentals never brought it to our attention – however there are lessons in this.

Reviewing their early letters is a painful exercise as we likely would have all been very, very wealthy if we picked it… but there are clear nuggets that in hindsight highlight a unique long-term mindset that's extremely rare.

1997 Amazon letter

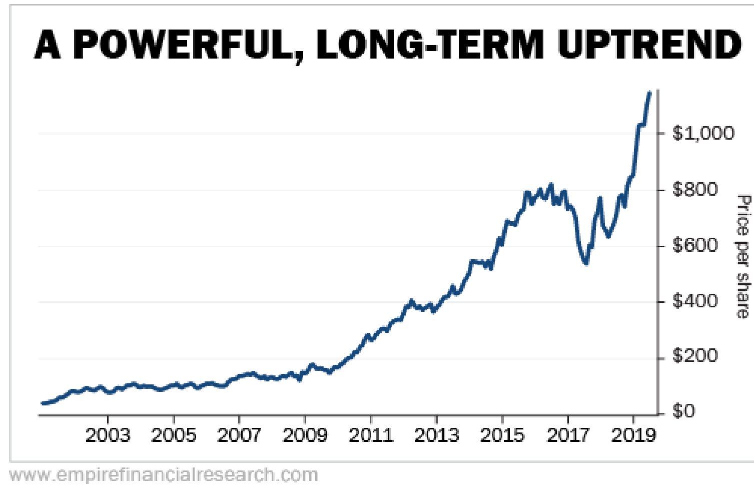
'It's All About the Long Term'. We believe that a fundamental measure of our success will be the shareholder value we create over the long term. This value will be a direct result of our ability to extend and solidify our current market leadership position. The stronger our market leadership, the more powerful our economic model. Market leadership can translate directly to higher revenue, higher profitability, greater capital velocity, and correspondingly stronger returns on invested capital.'

'Our decisions have consistently reflected this focus. We first measure ourselves in terms of the metrics most indicative of our market leadership: customer and revenue growth, the degree to which our customers continue to purchase from us on a repeat basis, and the strength of our brand. We have invested and will continue to invest aggressively to expand and leverage our customer base, brand, and infrastructure as we move to establish an enduring franchise.'
'We will continue to focus relentlessly on our customers. We will continue to make investment decisions in light of long-term market leadership considerations rather than short-term profitability considerations or short-term Wall Street reactions. We will continue to measure our programs and the effectiveness of our investments analytically, to jettison those that do not provide acceptable returns, and to step up our investment in those that work best. We will continue to learn from both our successes and our failures.'

Oh well, we missed it – perhaps we won't miss the next one.

2. Power of the buyback

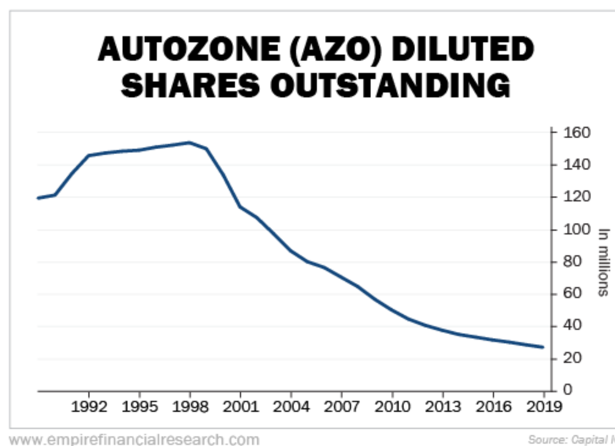
In January 2001, AutoZone (AZO) traded at $27p/s – today it trades at $1,250 – it's an astounding 47 bagger. However, digging deeper it's interesting to see what drove this return.



Source: Empire Financial research

Earnings grew sixfold over this time – which is very solid but not earth-shattering.
So, what was the real driver? Multiple expansion played a small part – it was trading at 13x earnings at the time and now trades at closer to 18x.

It really comes back to share repurchases and I think many people don't consider the incredible impact of such a regime. AZO actually repurchased 80% of its outstanding shares over this period.



Don't disregard the long-term benefit of a considered share repurchase program!

3. Identify compounders and avoiding the temptation to sell

We were recently reviewing old emails and found an email from August 2011 – we were in the midst of a European debt crisis and the world was nervous.

We started reviewing some share prices of solid ASX compounders – perhaps only identifiable in hindsight but compounders, nonetheless.

The key lesson in this for us – identify and review the compounders in your portfolio and if their compounding status holds, **don't sell.**

Love your compounders wholeheartedly and treat your cyclicals with lustful short-termism (the price changes below tell the story).

Share price performance of selected "cyclicals" and "compounders" from 11 August 2011 to today (23 January 2020)

Cyclicals

Company	11 August 2011	Today	% Return	% Return p.a.
Fortescue Metals (FMG:ASX)	$5.74	$12.47	+117.2%	+9.6%
Origin Energy (ORG:ASX)	$13.57	$8.57	-36.8%	-5.3%
Rio Tinto (RIO:ASX)	$69.74	$106.36	+52.5%	+5.1%

Compounders

Company	11 August 2011	Today	% Return	% Return p.a.
CSL (CSL:ASX)	27.46	305.56	+1,012.7%	+33.0%
ResMed (RMD:ASX)	2.61	23.87	+814.6%	+29.9%
SEK (SEK:ASX)	5.74	23.55	+310.3%	+18.2%

4. Work on your investment temperament, be patient and don't get distracted by noise.

In a world that is getting increasingly noisy – the true rational investor temperaments with a willingness to display patience in the face of this noise is rare. Our biggest investment learnings have not been analytical in nature but by adhering to delayed gratification.

Why? Because the world is terrifyingly noisy, and this fuels action over inaction. It pays to be good at what you are good at and not get distracted.

Investing actively requires a deep thought process and an ability to accept competence or incompetence. Its more than a hobby.

In 2015, Microsoft released a study that claimed that the average attention span had shrunk from 12 seconds to 8 seconds since 2000.

> ***"The research is almost unanimous, which is very rare in social science, and it says that people who chronically multitask show an enormous range of deficits. They're basically terrible at all sorts of cognitive tasks, including multitasking."***
>
> *—Clifford Nass, professor of psychology at Stanford University, speaking to NPR's Ira Flatow*

Source: Quartz daily obsessions

Q4 Reflection

It's hard to believe that in January we were completely disheveled after suffering a mini-bear market in December 2018. At that time analysts collectively called the end of the bull market, and naturally completely counter consensus. 2019 was a massive positive year as the Fed reversed its course and fueled markets with excessive oxygen via its lower for longer rate rhetoric.

What did we learn? Well, it's really hard to predict the outcomes of markets that are underpinned by the tone of the central bank's minutes.

'intelligence looks in the mirror and sees ignorance; ignorance looks in the mirror and sees intelligence.'

Act with humility and do not be afraid to be wrong, listen and continually be prepared to learn.

In light of what's going on in equity markets today, it's easy to lose patience and join the momentum trade. Earnings and cash flow will always prevail in the long term. Forever making that our investment horizon, where we focus on capital preservation and attractive risk adjusted returns for you, our valued clients.

"If a business does well, the stock eventually follows."

- Warren Buffett

It's simple and will never change!

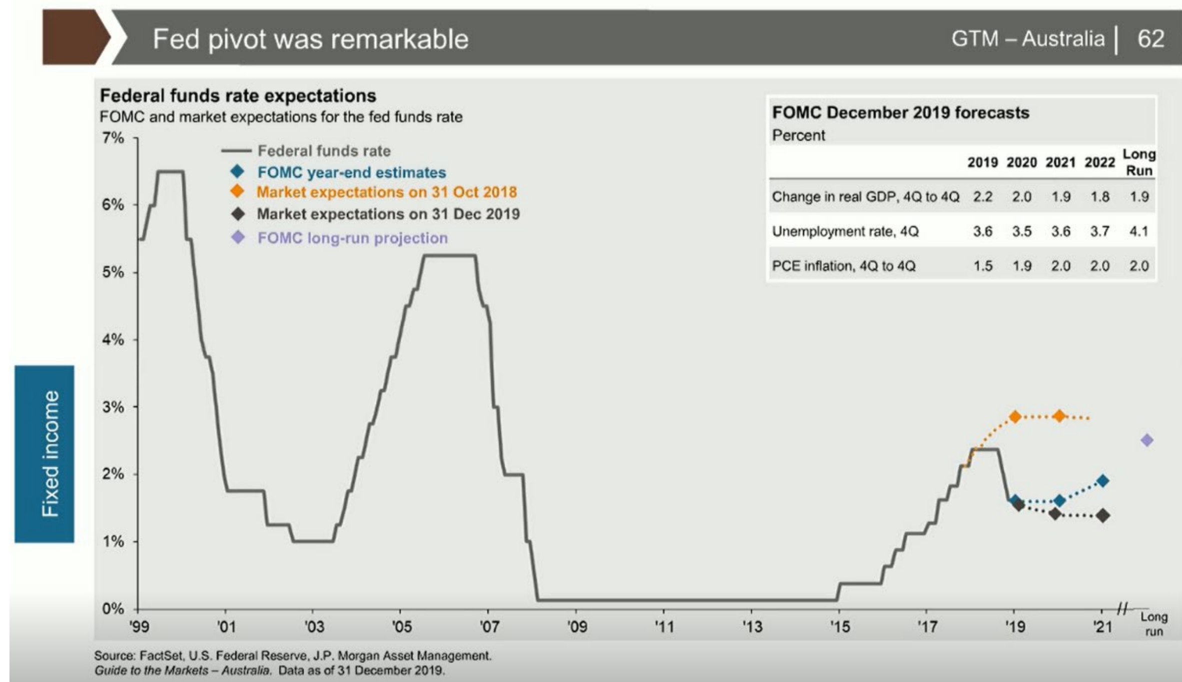
Chart of Quarter

For us, the below chart highlights perfectly and simply the reasoning behind the 2019 broad asset price appreciation.

As is the case with listed markets – it's a game of expectations and changes in Fed rate expectations shifted dramatically from October 2018 to 2019 (from going higher to lower for longer).

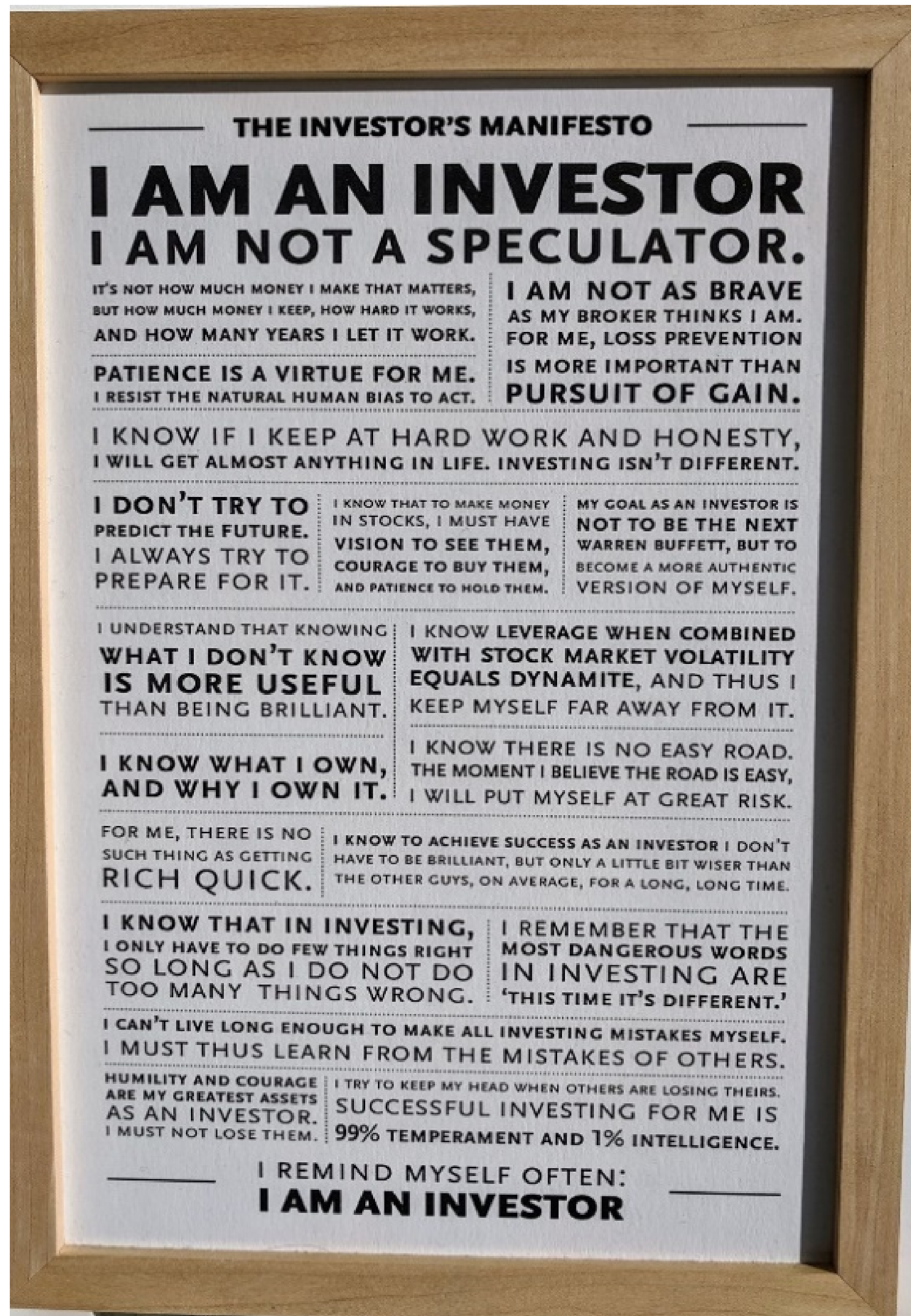
Simply, this provided the fuel to take markets higher.

The question to now ask – what are expectations for interest rates today – are they too high or too low?



Source: JP Morgan Asset Management

Photo of the Quarter



Source: third party newsletter

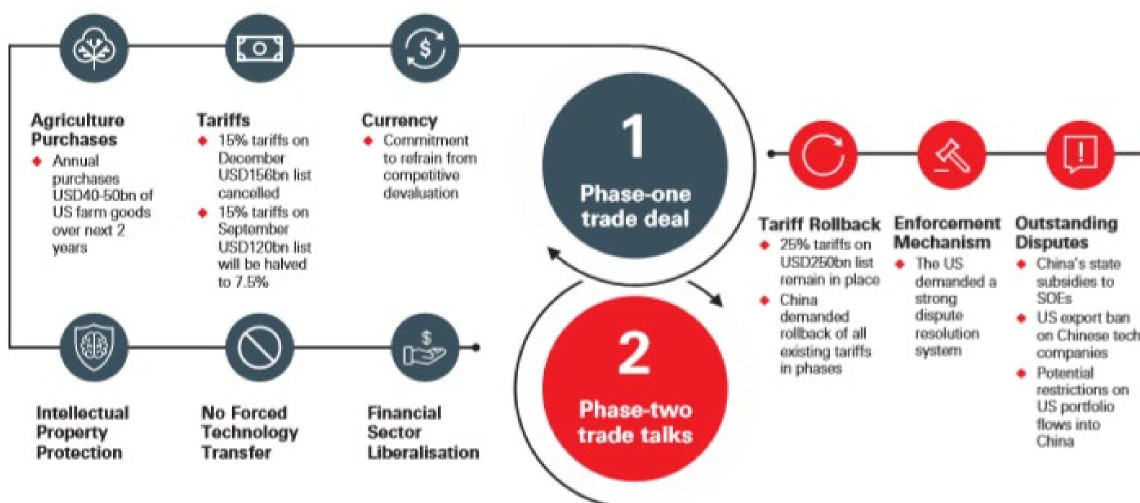
What happened with the Trade War?

Last quarter we discussed a chess board of how the Trade War could play out, if you can't remember perhaps take a look back at the 2019 Q3 newsletter. But as of December, a convoluted deal was agreed to, after a treacherous year of President Trump sending financial markets into a tailspin every time, he opened twitter.

The deal in summary:

- The US cancelled 15 per cent tariffs on about $150bn of Chinese goods that were due on 15 December and halved the tariff rate to 7.5 per cent on goods worth about $120bn that came into effect in September (while tariffs of 25 per cent on around $250bn in Chinese imports remain in place).
- In exchange, the Chinese government also cancelled tariffs that were due to be implemented on 15 December and agreed to substantially increase their imports of US agricultural, energy and other goods and services over the next two years, as well as tighten laws on technology transfer and intellectual property rights.

Whilst not a massive shift in stance it at least is a de-escalation and equity markets (which were really worried about this) really enjoyed it. Sentiment globally clearly has improved since and time will tell if it leads to an improvement in business investment across the globe. Attention will now shift to Phase 2 expectations (below) and Phase 1 will soon be forgotten.
Source: HSBC Economic research



History Repeats

What's the parallel to the 1930's?

Government spending programs designed to stimulate the economy were financed via money printing and debt. Similarly, this occurred post World War 2 as you can see below – US government debt peaked at 100% of GDP.

Source: Packer & Co investments

The problem with stimulation of this nature is the naturally occurring inflationary impact that has historically eroded conservative bond/cash investor returns in the sequential decades to come.
Savers lose in cash and bonds during inflationary periods and investors with real assets like property and shares fare much better.

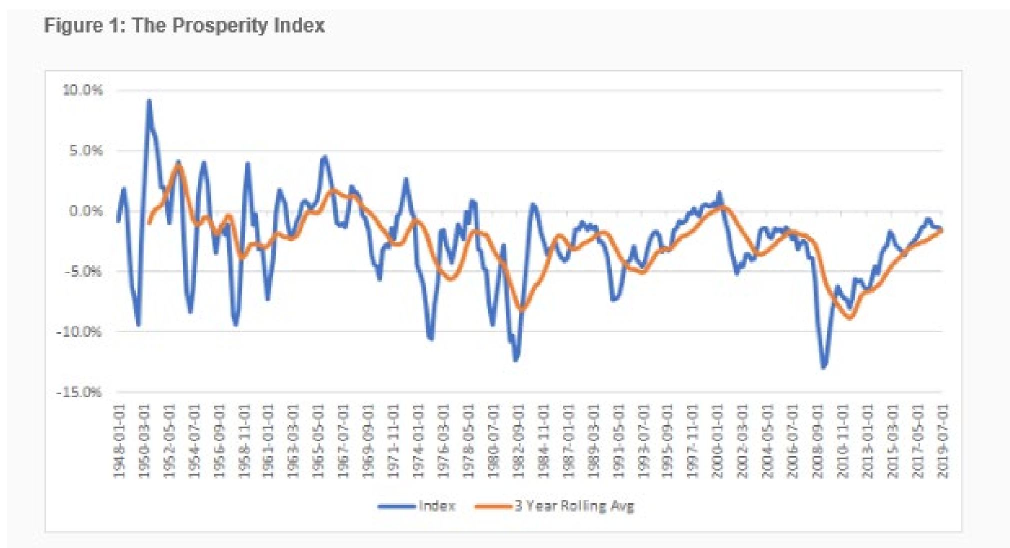
It's important to remain attune to history, irrespective of the narrative suggesting that we will experience permanently low inflation and interest rates. Investors in Argentina and South Africa know just how detrimental rampant inflation can be and it's important to remain conscious of history.

The Prosperity Index

The Prosperity Index is computed by subtracting the unemployment rate from the rate of GDP growth. **A high number equals a prosperous period.**

Does this help with forecasting returns? There's a curious thing about economic prosperity:

It happens to be negatively correlated with future stock returns… Why? Because share markets price in the expectation of prosperity.



Source: Verdad Investments

Prosperity Index (GDP Growth - Unemployment)	S&P 500 1Yr Fwd Return	Small Value 1Yr Fwd Return	Small Value Premium
Q1 -12.9% to -4.2%	18%	29%	11%
Q2 -4.2% to -2.3%	11%	15%	4%
Q3 -2.3% to -0.6%	12%	17%	5%
Q4 -.6% to +9.2%	9%	11%	2%

Source: Ken French data library, Capital IQ, FRED

Source: Verdad investments

Questions of the Quarter

It begs the question: Are we living in the 1930's revaluation 2.0 or the early 2000's exuberance 2.0?

Despite obvious headline distractions there are elements of a nuanced optimism:

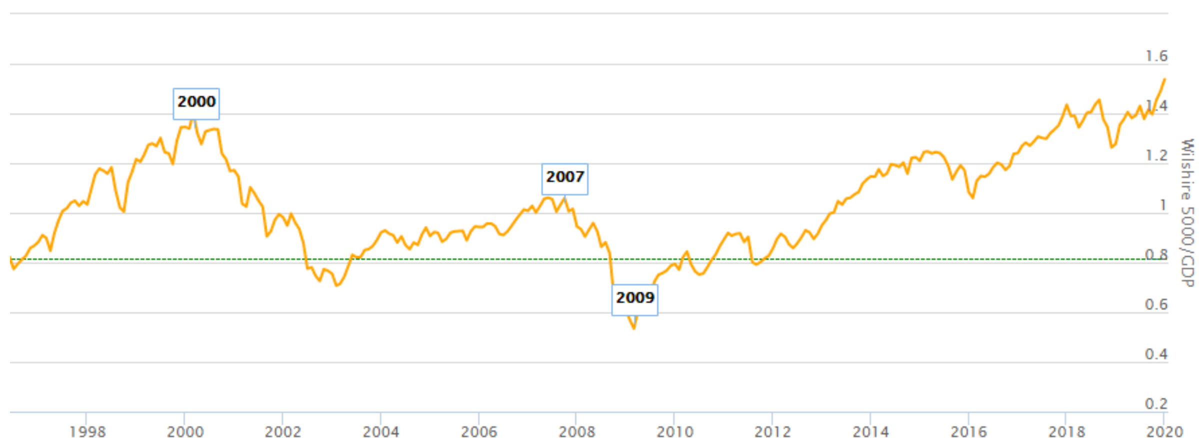
- Global growth expected to recover in 2020. Time will tell.
- The world was in a potential abyss 12 months ago (US-China trade war, Brexit, riots in Paris and Middle Eastern tensions).
- Fed seems to at least have stalled the prospect of raising rates. The US 10-year bond yield has fallen from 2.7% to 2% today.
- 20% of government debt now trades with negative rates (could never have forecasted this).
- It's hard for any exporters to not follow the US suit and raise rates through fear of currency appreciation. Rates could be lower for longer.
- The world fell into a similar dilemma in the 1930's post the great depression, as the US delinked from the gold standard to enable the financial system to reflate.

Macro indicator watch – expectations vs. outcome

Warren Buffet's favorite indicator (Market capitalization vs. GDP) hit an all-time high of 154.7% recently, approximately 1.6% higher than the 153.1% reading on Dec. 30, 2019 and 6.2% higher than the previous high of 140.5% set in March 2000.

What does this mean – well effectively equities now trade at a premium of 1.5x to global underlying GDP which means investors are prepared to pay a premium due to low interest rates.

Unfortunately, it doesn't help at all with timing the markets, but it suggests expectations are high.



Source: Longtermtrends

Valuation Watch

Are equity investors still being compensated with a risk premium?

Geometrical Average Historical Return		
1928-2019	S&P500	9.71%
1970-2019	S&P500	10.51%
2010-2019	S&P500	13.44%

Source: Musing on Markets

- Our favourite quantitative risk check – are we being compensated for taking equity risk- the difference between equity yield and the risk-free rate (government bonds)
- I.e. the difference in the earnings yield vs. the 10-year treasury rate of 1.92%

Implied Equity Risk Premium Calculator	
Implied Risk Premium in current level of Index =	5.20%

Historical Equity risk premium (US) =	4.82%
Historical Equity risk premium (Global) =	3.20%

- There is still effective risk compensation in the US at 5.20% vs. the long-term average irrespective of headline valuations.
- The risk premium on offer in emerging markets, Eurozone and Japan is much higher.

So why remain overweight stocks?

- Because stocks with true franchising power remain your best inflationary hedge over the long term.
- Valuations in unloved pockets remain reasonable, providing us with a sound alternative to holding cash or bonds.
- Shares on the whole offer earnings yields of circa 6% (greater in names we own) while long term bonds, as mentioned, provide a far less appealing 1.9% return.

Frustration / Crazy of the Quarter

In Q4 2019, Apple issued euro debt at a **0% coupon**. Let that sink in!

The world has completely and utterly mispriced the risk in our opinion. These bond holders are effectively saying we would rather pay Apple to hold our money than our own sovereign – doesn't speak much for the EURO, does it!

It's not that we disagree, what concerns us is how this has to unravel and who ultimately suffers the loss.

In 2012, Apple decided to take on some debt to return capital to shareholders (taking debt was tax efficient in terms of repatriating cash to US). The company has done this since then at different times, sizes and structures.

However, its most recent issue was interesting because it **was able to issue a euro-denominated bond with a 0.000% coupon.** In the table below, you can see the downwards progression of Apple's coupons – which highlights investors' willingness to accept 0% to know their capital base is secure (excluding the impact of inflation). This highlights the institutional investor with a mandated weighting to fixed income.

Great for Apple – not so much for the investor receiving nothing and taking credit risk.

Issuance Month	Maturity Month	Principal (m)	Coupon
November 2014	November 2022	€ 1,400	1.000%
	November 2026	€ 1,400	1.625%
September 2015	January 2024	€ 1,000	1.375%
	September 2027	€ 1,000	2.000%
May 2017	May 2025	€ 1,250	0.875%
	May 2029	€ 1,250	1.375%
November 2019	November 2025	€ 1,000	0.000%
	November 2031	€ 1,000	0.500%

Source: Seeking Alpha

Economic Policy

<u>RBA watch</u>

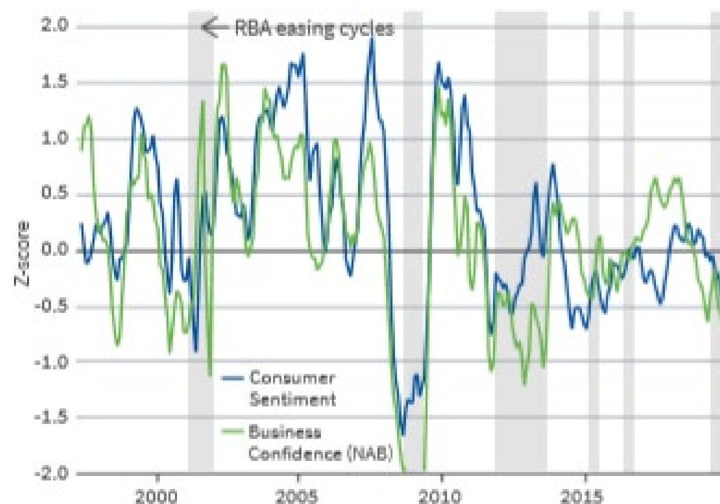
It's becoming consensus that we will see rates decrease further in Australia and perhaps see a touch of QE. It's hard to argue the other side in support of rate hikes.

It's well known that we have a very indebted consumer (2nd in the world). This is without considering Afterpay and all of its substitutes (effectively shadow banks).

Wage growth is very soft, as is housing construction. We started 2020 with low business and consumer sentiment and when we add in the terribly sad and significant bushfires it is very difficult to argue for higher rates in 2020.

We call 25bps before the end of 2020.

Unfortunately, in Australia we are reliant on housing credit growth and as a result we need the RBA to massage this problem. This means lower rates and perhaps a looser credit policy (i.e. lending at 95% - what could go wrong?).



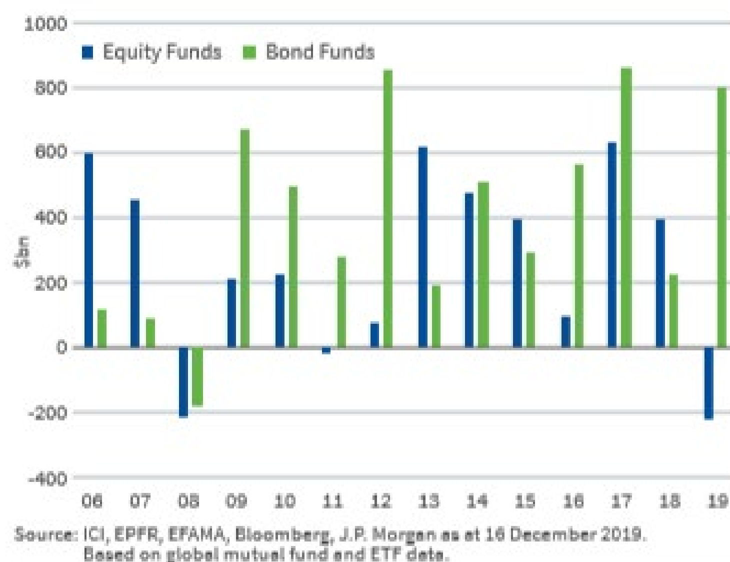
Fed to hold or to ease? That is the question.

It's apparent that consensus is for rates to remain on hold in 2020 (because to be honest this is recency bias and the easy stance to take). **More of the same in the wake of muted inflation.**

Let's hope we see contained inflationary pressures and rates on hold.

In this environment its pays to remain tactically overweight equities.

The fed holds the key to asset prices and not much has changed – positively the aggregate investor remains cautious (given a soft 2018) with net outflows from equities. Our guess is this reverses in 2020 on the back of a strong 2019.



The Passive Bubble

To us, at this stage of the cycle, it no longer makes sense to be in the momentum trade. The modern passive investor is saving basis points by switching to passive strategies, only to potentially get crushed when over 80% of their fellow investors become price-agnostic sellers. It's the definition of picking up pennies in front of the steam roller. We want no part of this game, and have been actively working to eliminate all exposure in our portfolio to

Most active investors hope so!

Source: Seeking Alpha

Lesson of the Quarter

Sometimes it works to go against the crowd

- There will always be winners and losers in any industry or sector regardless of the broader outlook. At Alvia we always get excited when peak sector pessimism drops a sector into the too hard basket.
- Many commentators are more than happy to share their forecasts and views on the prospects of a particular industry without having an intimate knowledge of it through a lens of consensus extrapolated negativity.
- We look through this to the facts to find where this positive or negative sentiment towards a particular company or sector can provide investment opportunities. As we've written about previously, in Australia there has been a lot of crowding in a number of companies that are perceived to have high growth prospects.
- Whilst we acknowledge some of these businesses are of high quality, their share prices in many instances have lost touch with reality.
- One sector that has largely been out of favour due to broader market sentiment is Australia's retail sector. Our **Australian equities portfolio** consists of a number of retail / consumer investments with the below graphic showing the investment performance since we entered each of these positions during the last 12 months.
- It's a prime example of the 'Mr/Mrs Market' bringing opportunities to you and being courageous enough to participate post doing the work on them.

Source: Bloomberg

Do as I say, not as I do?

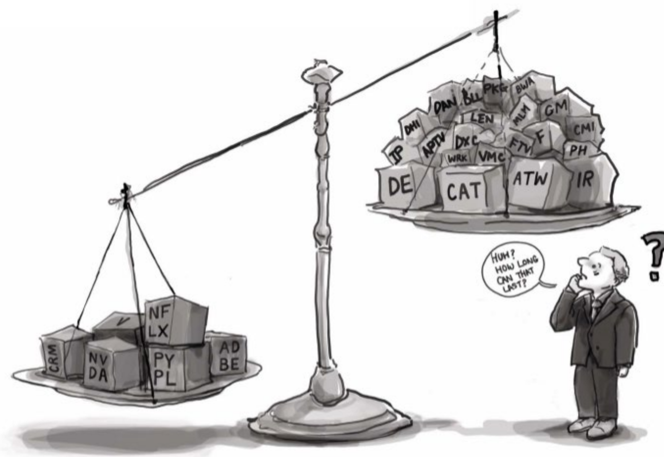
It's always confounded us that in most cases we privately act with a value mindset – we seek to buy personal items on discount and love to brag about bargains, however, when it comes to investing, we lull ourselves into believing we can forecast growth into perpetuity and gain comfort in buying into price momentum – its illogical.

We have written a lot about the everlasting bull market for large capitalisation growth stories and perpetually recurring SAAS revenue technology stocks, but we want to raise it again, as the priority status for revenue growth at any cost associated with bottom line losses has attracted huge valuations.

The dispersion between the disruptors at any cost and the perceived disrupted remains at multi- year highs and we believe that the dynamic is shifting.

Investing 'styles' float in and out of favour and for this reason we continue to believe that an inflection point has emerged for a rotation back to the fundamentals of valuation-based investing – i.e. not TAM (Total Addressable Market) speculation.

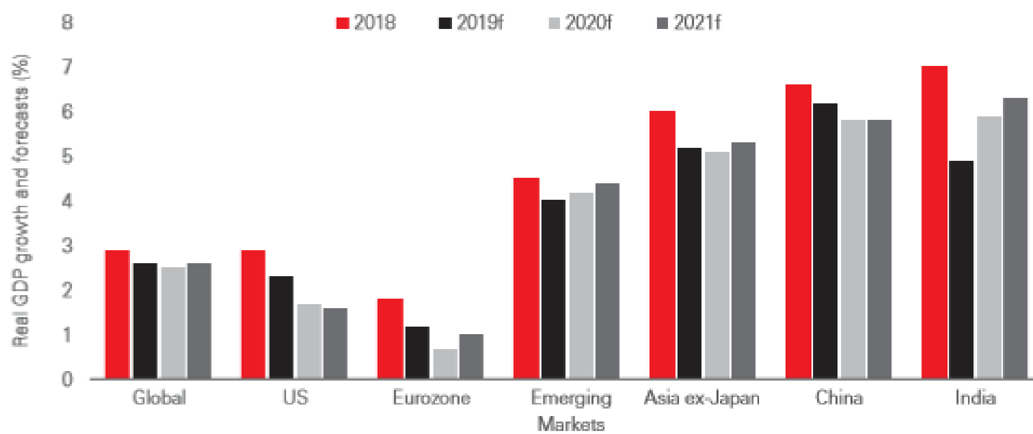
We know the cause of this speculation relates to a zero-interest rate policy which has fueled risk taking, inflated asset pricing and reduced global discount rates to a point that risk has become very cheap. We believe that the relative opportunity now presents itself for the astute investor to pick carefully amongst the ignored end of the market, assuring one avoids the value traps (as evidenced below).



Tactical Asset Allocation

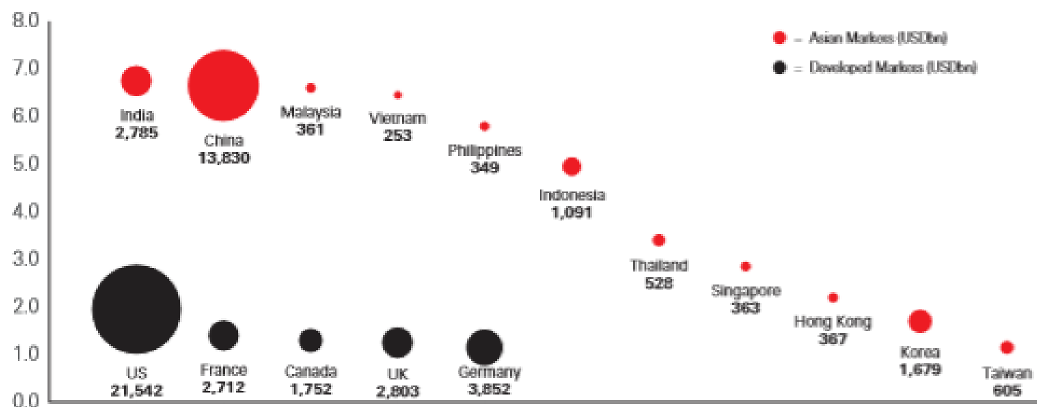
- We remain strategically overweight to emerging markets, in particular in Asia.
- The premise is simple – Asia continues to outgrow developed markets and its own emerging counterparts (see below).
- This growth is not reflected in market prices.
- Markets revert to equilibrium over time for those that are prepared to remain patient.
- Expected returns in Asian EM are therefore much higher than developed markets.
- Asian market consumption growth due to rapid urbanisation continues to support local economies.
- Headline relative valuations support a rotation from developed market weighting to emerging markets.

Slow for longer: Asia outperforms DM and EM peers in economic growth



Asian consumption growth stays well above levels of developed economies

Average real consumption growth in 2020-21, in %



Source: HSBC Global Economics Quarterly Q1 2020. HSBC Private Banking as at 31 December 2019.

Family Wealth Management

Thought of the Quarter

- The hardest challenge we find discussing long term investment management with families is always narrowing down the right level of risk and return to prescribe.
- Unfortunately, there is no right answer and all families are different and this is therefore incredibly personal.
- However, perhaps there is a simple framework that can at least help guide the conversation in respect to setting investment return objectives. That is assuming the goal is to transfer the wealth intergenerationally (which is almost always the case).

First consideration:

- What's the family growth rate? Families compound wealth quickly (they actually double their corpus on average every 20-30 years) and there is some evidence that high net worth families grow more quickly.
- Let's assume 2.5x every 25-30 years.
- **Therefore, the first hurdle is roughly 3.5% to meet sheer family member growth.**

Second consideration

- We need to consider funding current members – assuming there is a need to fund some beneficiary activity of the current generation. This will place obvious liquidity and risk restraints on the family portfolio – making it difficult to take significant illiquid growth positions.
- Safe to assume circa 2% required to fund this current beneficiary profile.

Third consideration

- Clearly inflation plays its part and there we have to contemplate the long-term inflation profile.
- Safe to assume the long-term average is circa 2.5%

Fourth consideration

- Fees for appropriate advice is circa 1%.

Final consideration – Tax!

- Tough one to estimate depending on structure and domicile, etc
- Let's assume at least a 1% drag to surpass.

Putting this all together it equates to a target rate of 10% required to compound into perpetuity which is no small feat over the long term.

Source: Family capital strategy

Berkshire Watch

Let's close out with a simple conservative stock tip for 2020 (hard to pick on a 12-month timeframe).

- Is it time to back Mr Buffett & Mr Munger again? See tweet below. They just came off the worst relative market performance in a long while (-13%) and last time this occurred that put on some very strong 3 years following.
- It's a very simple way to bet on a value rotation out of the well owned growth names.

Lawrence McDonald
@Convertbond

.@WarrenBuffett under performance vs. S&P 500:

2019: -20%
2018: +7%
2017: 0%

At -13%, worst three years against the market since 1997-99. After which he went on to outperform by 75% the following 3 years. Bloomberg data. Value vs Growth alert.

Source: Lawrence McDonald Twitter

Predictions for 2020

1. What occurred most recently in 2019 will shape how you view this year. **Recency bias** will take hold and because 2019 was a good year, you will presume the same for 2020. What we do know is that it won't be the same. Don't get too excited…

2. Something weird will happen that will capture the attention of market participants and it will be deliberated broadly. It might be geo-political, it could be the new bitcoin, but it will be out of left field.

3. You will panic at some point on a short-term rough period and you will want to act when the best thing for your portfolio will probabilistically be to do nothing. Let auto-pilot do its thing.

4. Sadly, your neighbour's neighbor will be doing something really cool with their money – hitting home runs everywhere – remember envy destroys portfolio outcomes.

5. Asset allocation will continue to be more important than equity / bond / property / commodity / FX picking.

6. The best hedge will continue to be holding a cash buffer accumulated by a solid saving rate.

7. You will wish you owned more of the best performers and less of your poor performers.

8. Luck will play its part in your / our outcomes. Process is more important.

9. Diversification will mean you hold things at the wrong times and you will feel dumb and that's ok as it can change quickly.

10. Hindsight will make things look very clear cut when they are not.

11.