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ASSET PARTNERS

Alvia Asset Partners Investment Team Insights

March 2019 Quarter

General Commentary – *A focus on Investor Behaviour*

Instead of giving you an update on how the market performed, what new economic data has been published etc… we thought we would provide you with a look at investor behaviour.

Why…well the last 6 months has been an extraordinary ride and a perfect case study.

So, what happened, and for those who went on holiday from *September- March* here's a hint… nothing changed. Bar plentiful volatility (wild ride indeed)!

Source: Bloomberg, ASX200 Index

For those with room to move and the ability to maintain emotional stability, this period has provided an opportunity to deploy cash into a flighty market. It appears Mr Powell woke up one morning with a horse head in his bed and very quickly reversed course on Fed tightening, essentially putting a new put under equity markets.

Learnings in Private Family Money Management

You aren't an institutional superfund, or a Hedge Fund so don't act like one, go your own way... It's actually a significant benefit not a cost.

1. Take your time and design an anti-fragile system (don't compete with anyone)

It's important to have a background assumption that there's no hurry. Sit on cash as a default. The stock market could be going vertical right now, it could be plunging. What the market is doing is irrelevant. What your friends are doing is irrelevant.

Don't get on the envy trolley; sit in cash and enjoy it. Your only competition is your ego and inflation it is not the Future fund!

Antifragility is the combination of aggressiveness plus paranoia—clip your downside, protect yourself from extreme harm, and let the upside, the positive Black Swans, take care of itself.

2. Identify what you're good at and how you're going to use it as a strength

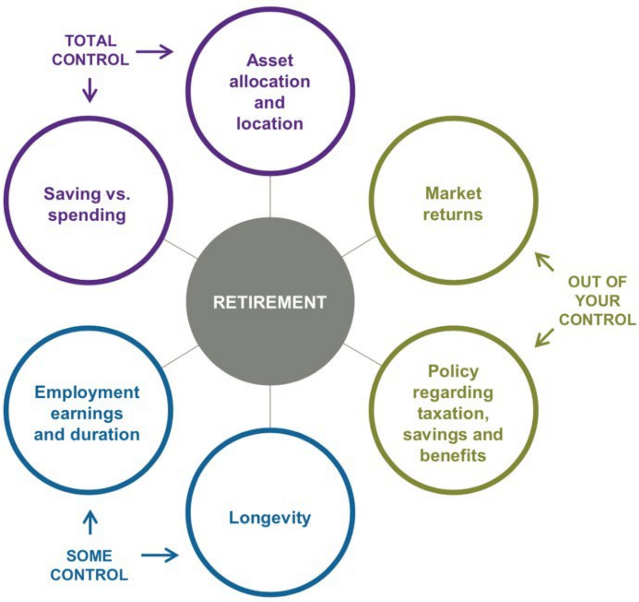
First try to establish what you and the people you know believe you have a lot of credibility in doing what you do. You need to assess your own credibility and that of potential partners, using this to decide on how to divide your capital.

Credibility = proven competence + relationships + integrity

If you don't trust the people to manager your money, sit in cash; if you do, give them the money and follow the "eyes on, hands off" policy.

3. Control the controllable

1. Asset Allocation
2. Spending (Ego) vs. Saving



Source: J.P. Morgan

Behavioural Economics Lessons for the Quarter

Are market participants perfectly rational?

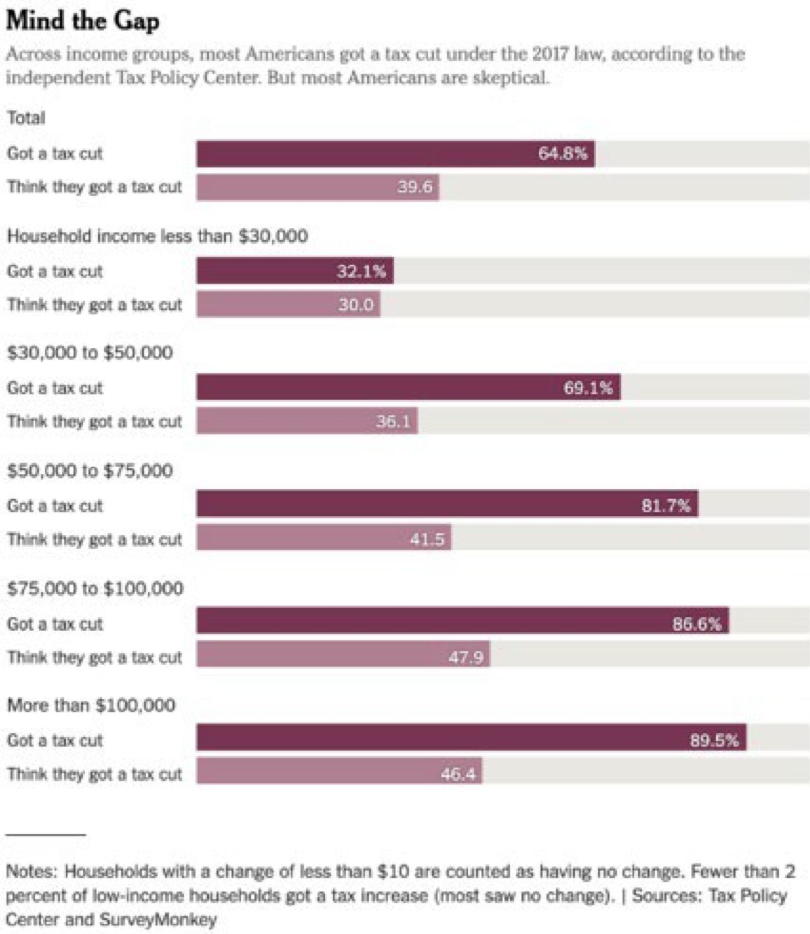
A recent study in the US highlighted that the majority of taxpayers were distressed about a smaller tax return this year – really?

The same study highlighted the same majority weren't aware they received a tax cut (see below).

Lesson 1 – The small stuff matters

People irrationally disregard small month to month changes as its doesn't feel like a big win, even though the compounded benefit of any tax cut is momentous over the long term.

Where's the instant gratification in getting rich slowly by compounding your income savings when you can just buy more acai bowls? 😉😉



Source: Tax Policy & SurveyMonkey.

Lesson 2 – Turn off your notifications or go bald worrying… it’s up to you.

How to reduce portfolio losses by 20%?

Trust your portfolio managers and look at your portfolio once a year as opposed to everyday. For a simple 60/40 portfolio, this is how often you’re likely to see a loss in your portfolio:

- 46% of all daily returns
- 36% of all monthly returns
- 33% of all quarterly returns
- 26% of all yearly returns

Lesson 3 - Keep it simple and repeatable and actively think before you act!

From the book, *Thinking Fast and Slow;*

‘The best - known and most controversial of our experiments involved a fictitious lady called Linda. Amos and I made up the Linda problem to provide conclusive evidence of the role of heuristics in judgment and of their incompatibility with logic. This is how we described Linda:

Linda is thirty-one years old, single, outspoken, and very bright. She majored in philosophy. As a student, she was deeply concerned with issues of discrimination and social justice, and also participated in antinuclear demonstrations.

We asked this simple question: Which alternative is more probable?

1. Linda is a bank teller.
2. Linda is a bank teller and is active in the feminist movement.

85% to 90% of undergraduates at several major universities chose the second option, contrary to logic.'

It tells us to keep the process simple but think deeply before we act.

Are we nearing an Oz Recession?

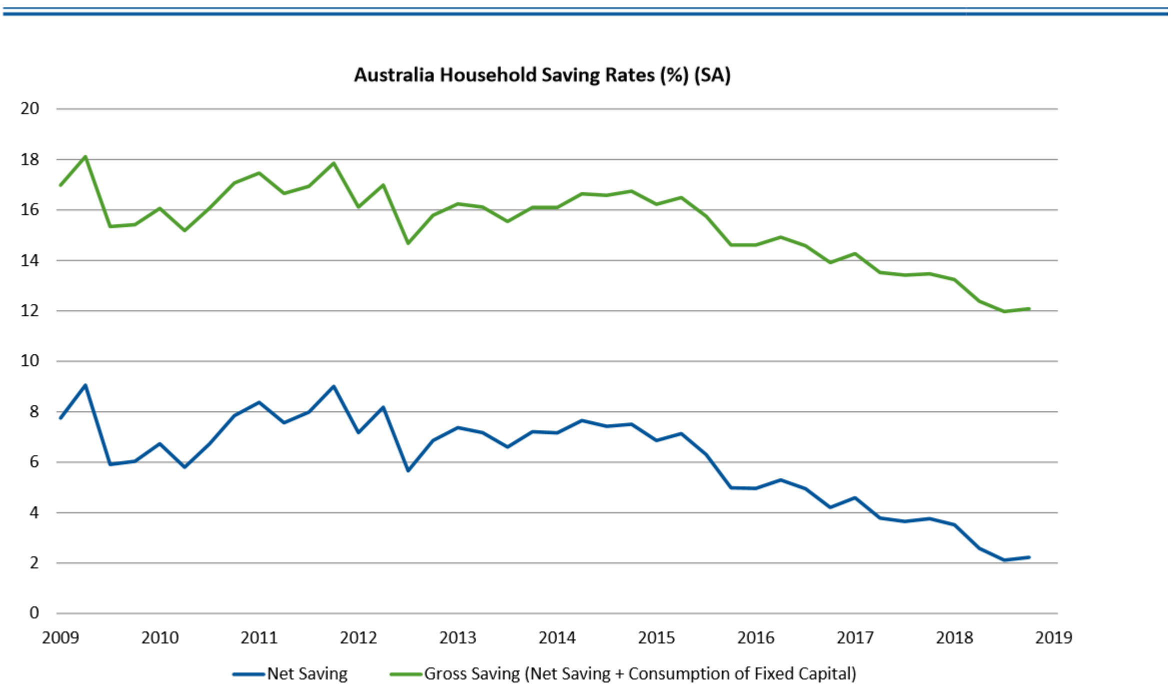
Headline CPI for the March quarter was 0.0%, and just 1.3% for the full year. Much lower forecast and meaningfully below the low end of the RBA's 2.0% annual inflation target.

Event	Period	Surv(M)	Actual	Prior	Revised
CPI QoQ	1Q	0.2%	0.0%	0.5%	--
CPI YoY	1Q	1.5%	1.3%	1.8%	--
CPI Trimmed Mean QoQ	1Q	0.4%	0.3%	0.4%	0.5%
CPI Trimmed Mean YoY	1Q	1.7%	1.6%	1.8%	--
CPI Weighted Median QoQ	1Q	0.4%	0.1%	0.4%	--
CPI Weighted Median YoY	1Q	1.6%	1.2%	1.7%	1.6%

Source: Bloomberg

Bonds have rallied aggressively with three-year government bonds are now yielding just 1.30% and ten-year bonds 1.80%, with the cash rate just 1.50%. The market is now expecting at least two rate cuts this year.

Low inflation, stagnant wage growth and employment capacity would normally make it an easy call for the RBA to cut rates, especially when you throw in falling house prices. However, with a highly geared household and minimal savings in the kitty (below) it's a very difficult proposition for the RBA.



Source: Franklin Templeton Investments, Australian Bureau of Statistics, Reserve Bank of Australia

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We are happy to bias cuts over hikes.

Yield Curve Inversion Hysteria Q&A

The yield curve inversion is a situation where a 10-year government bond yield dips below the 3- year government bond yield.

Essentially this means you are being compensated more for taking on less risk... Historically, this inversion indicates an increased likelihood of recession.

Time will tell on whether the tea leaves are right in this case – it's a historical leading signal but absolutely nobody knows whether it means anything this time round.

From our perspective it makes sense to ensure we remain defensive at an asset class level and robustly test all underlying valuations of everything we own. Cash is a free option on anything.

It's all about the signals... the problem being only hindsight will confirm a signal.

Source: google images

Traders have been forever using market signals to try and preempt market moves.

Dating back to the early 1600s Dutch traders used the invention of the telescope to their advantage. Traders during this time would observe ships approaching port carrying commodities, and project commodity cargo size through how low the vessel was sitting in the water. Using the information gathered, buy and sell orders would be placed before the ship hit the docks and anyone else traded.

As long term investors it's important to remain aware of history but to be also skeptical of relying on signals to confirm bias.

Historically, what has happened to Equity Markets post Inversion?

See below – defensive consumer staples have outperformed the index by over 20%.

Stapes vs. S&P in a Post-Inversion Regime

Staples Outperformance: After 3m10y Inversion			
Inversion to Peak Outperformance	XLP	SPY	Outperformance
07/03/00 - 10/04/02	-20.42%	-44.95%	24.53%
07/19/06 - 11/21/08	-10.50%	-38.10%	27.60%

Source: awealthofcommonsense

But how do you play defence when defensive equities are already expensive?

Focus on asset allocation.

But what about the bond bubble?

Fixed income has a place irrespective of your view. See below.

S&P 500 Worst Days	10 Year Treasuries Worst Years
-20.47%	-11.12%
-12.94%	-9.10%
-10.16%	-8.25%
-9.92%	-8.04%
-9.12%	-5.01%
-9.07%	-4.96%
-9.03%	-2.99%
-8.93%	-2.65%
-8.88%	-2.56%
-8.79%	-2.26%

Source: awealthofcommonsense

But what about the impending economic slowdown/recession?

Note: Dow earnings were cut in half during 1908, yet the index still managed a 46% gain…

The stock market ≠ the economy.

Stop using the economy to time market entries. **It's a very noisy economy.**

"If you aren't willing to own a stock for 10 years, don't even think about owning it for 10 minutes." -Warren Buffett, CEO, Berkshire Hathaway

Bull Case for the Quarter

Mr/Mrs Market is trapped between these two states of minds:

1. "I see trees of green, red roses too, I see them bloom for me and you, and I think to myself what a wonderful world."

2. "It's gonna be cold, it's gonna be grey and it's gonna last you for the rest of your life."

Pessimism remains in a unloved bull market and euphoria is under control. Consensus is for a collapse. Markets tend to climb the wall of worry and it is plentiful.

Is it time to scream bear?

I love using John Hussman as an example – this guy is just the best.

He is calling for a 60% market drawdown resulting in $20 trillion in losses (nice big round numbers tend to sell well). Like when your federal minister brings forward 10 years of spending to highlight how they are going to spend $20 billion on infrastructure (I digress).

What many people don't actually know is John Hussman has been warning of a stock collapse for over a decade now and subsequently his numbers for the decade are -5.56% pa versus the market of 14% pa.

Doing the numbers, it actually turns out that investors in Bernie Madoff's Ponzi after bankruptcy clawback will actually outperform Hussman (no joke).

Pessimists will always be around, just don't let them make you leave with half your money on the table!

Bear Case for the Quarter

We continue to be in long bull market cycle and there are signs of economic deterioration as per below – cycles by nature revert. We live in a constant state of trepidation waiting for the unavoidable sell off.

The 12 days of fed rate tightening cycles

The usual order of events as per the past 12 Fed tightening cycles…before; during; and after

(Red text indicates what has already happened)

- The yield curve flattens
- Money supply growth slows
- Housing sentiment and activity weakens
- PMI's decline
- P/E's decline
- Earnings revisions decline
- Market volatility rises
- Credit spreads widen
- Earnings growth slows
- Consumer confidence declines
- Market returns flatten out
- The Fed stops hiking
- Equity Market relief rally
- The ISM declines below 50
- Employment weakens
- EPS recession
- Fed Cuts Rates
- …….

Source: Talaria funds management

Where is all the Inflation?

Gold and the precious metal miners have been rising consistently. With a stable US$ during this period and no adjustment in inflation, why is gold increasing?

The most obvious answer is the Fed's decision to temporarily halt rate increases. Quantitative tightening winding down earlier than expected, more dovish central banks, negative yielded bonds traded on the rise, all obvious answers, however, we want to explore beyond the simple answer as this doesn't quite satisfy us.

We along with Eric Cinnamond subscribe to the Tiny Toilet Paper Rolls theory (TTPR).

Take an imaginary fund manager named Louise, she runs her portfolio the old-fashioned way – via fundamental analysis.

After another quarter of rising corporate costs, lower promotions, and higher average unit prices, Louise was growing increasingly confused. Louise asked herself, "Why aren't these trends spilling over into the government's inflation data?"

Stumped, Louise decided to step away from her Bloomberg to take a restroom break. Whilst toilet prices aren't increasing – it's interesting to see the size and likely quality decrease of toilet rolls decrease.

Shrinkflation?

Source: Eric Cinnamond (Absolute Return Investing)

Worry of the Quarter

We continue to live in amazement at the achievements of the unicorns and "profit maybe one day in the future companies"?

We must be getting close to peak Storytime?

Lyft IPO anyone? Far out.

The euphoric 20x oversubscribed listing of Lyft on 29 March saw memories of 1999 come flooding back. It priced at $72, opened at $86.60, closed day one at $78.30 and then closed day two below the IPO price at $69. A classic case of surge pricing.

Challenge the narrative… stories are worth very little over the long term!

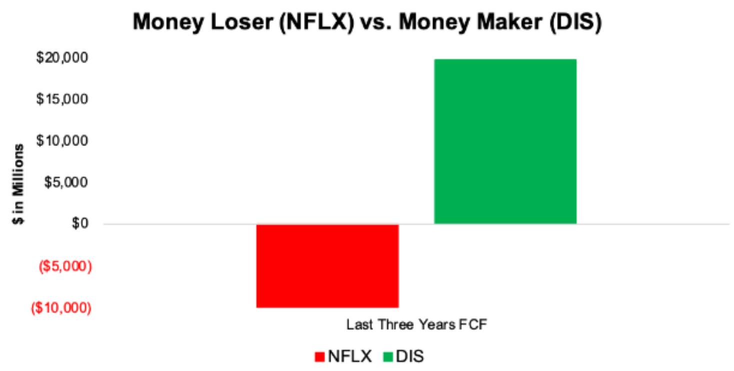
- Tesla and Netflix are renowned for being the two largest growth stocks in the world.
- This is why we think they are part of the biggest single stock bubbles in the growth stock bubble market.
- **<u>Own value… the dispersed opportunity set is massive.</u>**

Tesla (NASDAQ: TSLA) – our personal favourite story stock.

- Tesla has no electric vehicle "moat" of any kind; i.e., nothing meaningfully proprietary in terms of design or technology.
- Tesla is now a "busted growth story"; demand for its existing models has peaked and it will have to raise billions of dollars to produce new ones.
- Tesla is again losing a lot of money with a terrible balance sheet.
- Elon is a salesman not a business man.
- In March they announced (spur of the moment cost saving measure?) they were closing 90% of their retail stores to then only backtrack and close only 50% (probably after someone told Musk that the company was still on the hook for all the leases anyways). Sound business mind?
- Tesla's quality is now being questioned (see below) and it lacks a sustainable competitive advantage with Audi, Jaguar, Mercedes and BMW all coming with premium EV models.
- **First mover advantage does not equal competitive advantage.**

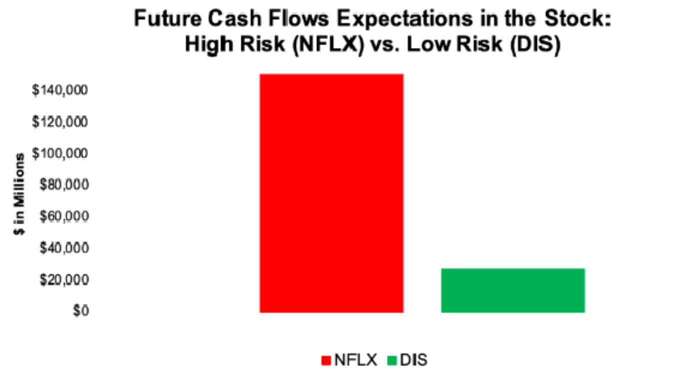
Netflix the number 2 story stock...

Figure 3: NFLX Loses Billions While DIS Makes Billions



Sources: New Constructs, LLC and company filings

Figure 4: Cash Flow Expectations for NFLX Are Dangerously High



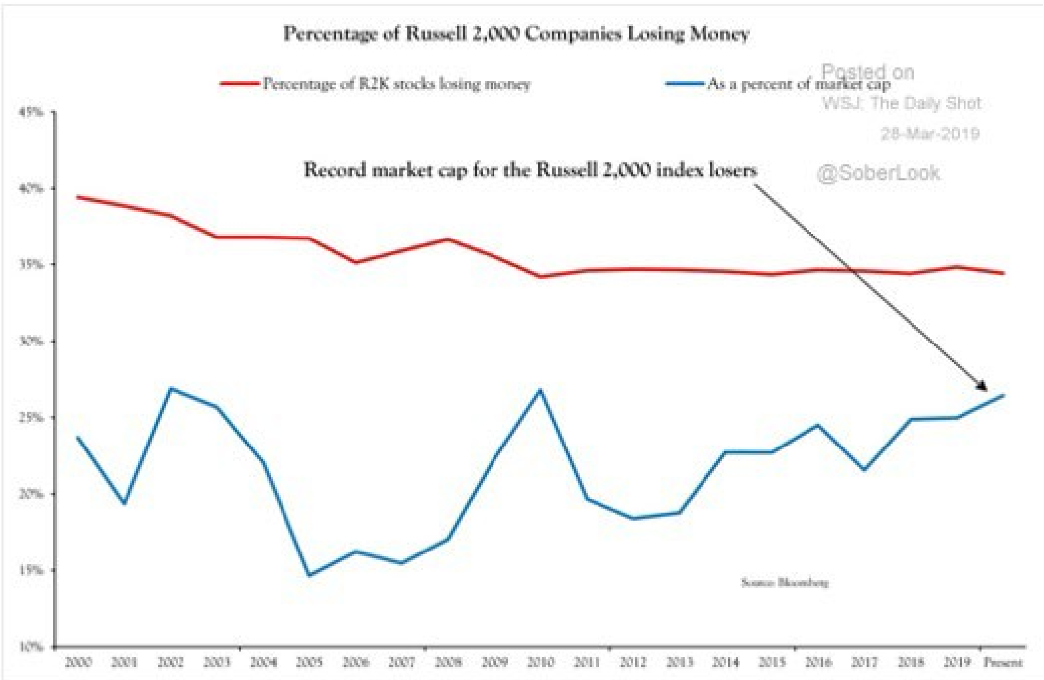
Sources: New Constructs, LLC and company filings

Why own Netflix when you can own DIS?

- First mover advantage is not a competitive advantage

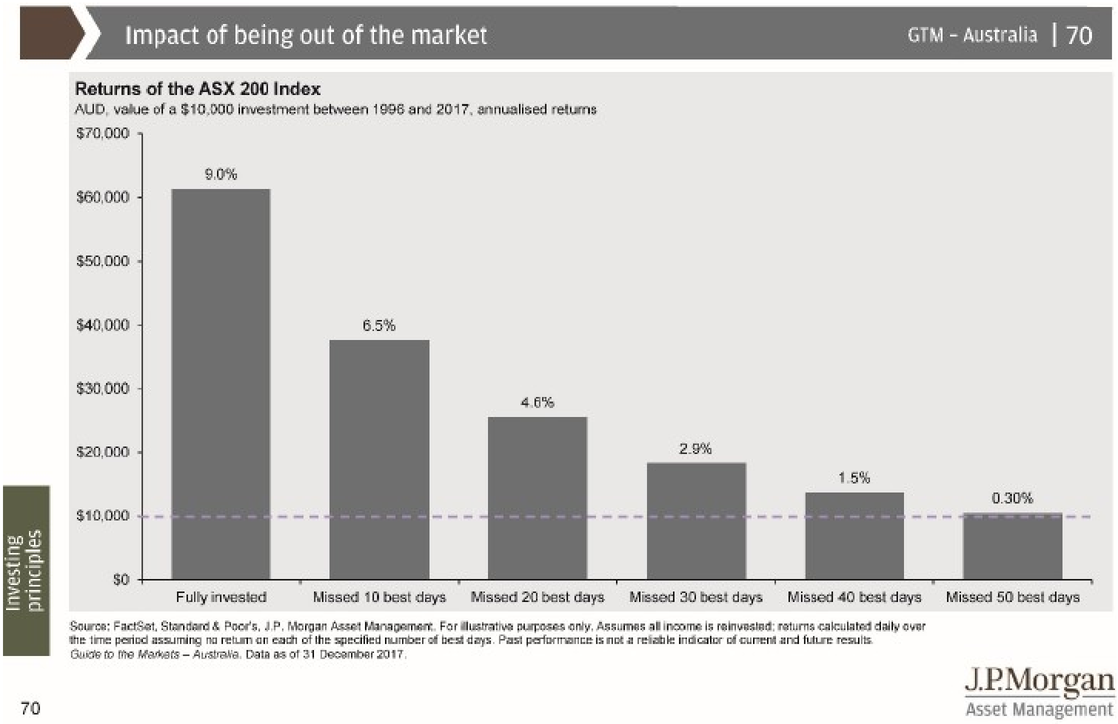
Conversely, we see Disney as a winner when the micro-bubble bursts. 31/03/2019, Disney's valuation is depressed due to overblown fears that Netflix will hurt the profitability of its existing business.

Are we peak easy money no profit/story telling euphoria – perhaps?



With all this doubt it begs the question, “Why am I still in the Market?”

Because significant value exists if you are prepared to ignore the excitement. We truly believe there is a significant opportunity to own ignored disregarded free cash flow generating value assets **and market timing is a fool’s errand!**



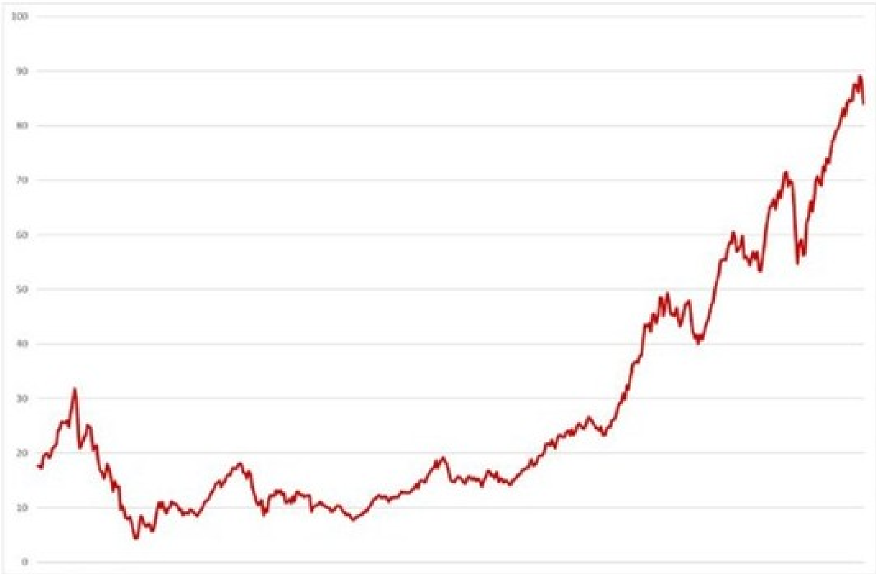
Source: JP Morgan

Another Note: The Dow has compounded at less than 3 basis points a day since 1970, since then it is up 3,000%

You’d have to be cuckoo to want to actively ‘opt out’ on long term compounding magic.

Chart of the Quarter

Q: What would you say if somebody came to you and asked for your investment in a company, however, you can only act on the chart below. (source Fundsmith fund managers).



Source: Bloomberg

Surely you would say 'go away, this is the peak'........................?

The above is Berkshire Hathaway at the time the big Buffet acquired them (1965) and by displaying your exceptional technical analytical genius skills you just gave up 20.9% annualised over the next 50 years or so. Berkshire 1990-2019.

Since 1926, stocks have produced a positive return in nearly three-quarters of the years - 73%, to be exact.

Consider a gambling analogy: A roulette wheel has 18 black and 18 red numbers, so after enough spins, each color comes up equally.

If an "investment advisor" was always suggesting to invest in black, it would be fair to be dismissive of that advice. But what if a roulette wheel had 26 black numbers and only 10 red, and the payout was the same on both colors?

Source: Bill Nyren, Oakmark

Quote of the quarter

"When you become rich, the pain of losing your fortune exceeds the emotional gain of getting additional wealth, so you start living under continuous emotional threat. A rich person becomes trapped by belongings that take control of him, degrading his sleep at night, raising the serum concentration of his stress hormones, diminishing his sense of humor, perhaps even causing hair to grow on the tip of his nose and similar ailments. Seneca fathomed that possessions make us worry about downside, thus acting as a punishment as we depend on them.
Even more: dependence on circumstances — rather, the emotions that arise from circumstances — induces a form of slavery."

- Nassim Nicholas Taleb

Self-Reflection/Idea generation

Name a product, company or service you use that you would pay a lot more for than you currently do? Good place to start when looking for investments.... Our team #1 answer Water, #2 Google Maps.

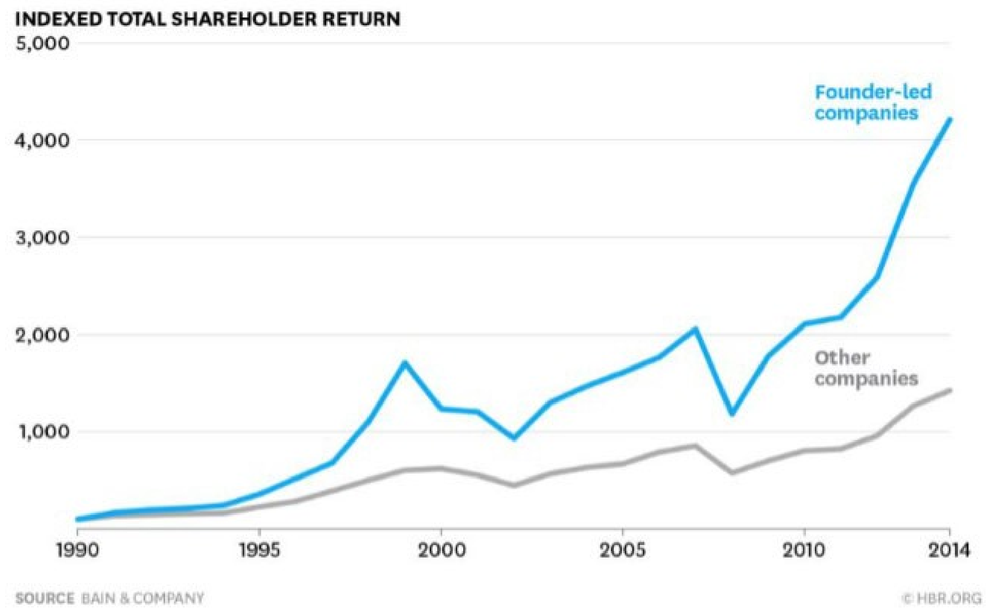
Source: Patrick O'Shaugnessy

Client Question of the Quarter

Q: Everybody says they invest in quality - define a quality company represented in simple terms with an example?

Answer: It generates a sustainably high return on capital well above its cost of capital brought about by its moat with sustainable margins, a high conversion of cash available to its owners with very little financial leverage or engineering… ideally bought at a very reasonable price discounting its growth prospects led by an appropriately incentivised leader.

Founder led companies generate more value:



Example: Facebook (FB) which we bought in 2018.

- It has 1.5 billion daily users (decent barrier to entry);
- Return on capital and operating margins both north of 30%;
- Growing at 30% with PE on entry less than 20.
- Thanks Mr Market for providing us with this opportunity to own FB (we have waited years!).
- <u>It is a founder led company (see below)</u>