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Financial Advisers

Stanford Brown Monthly Top 5

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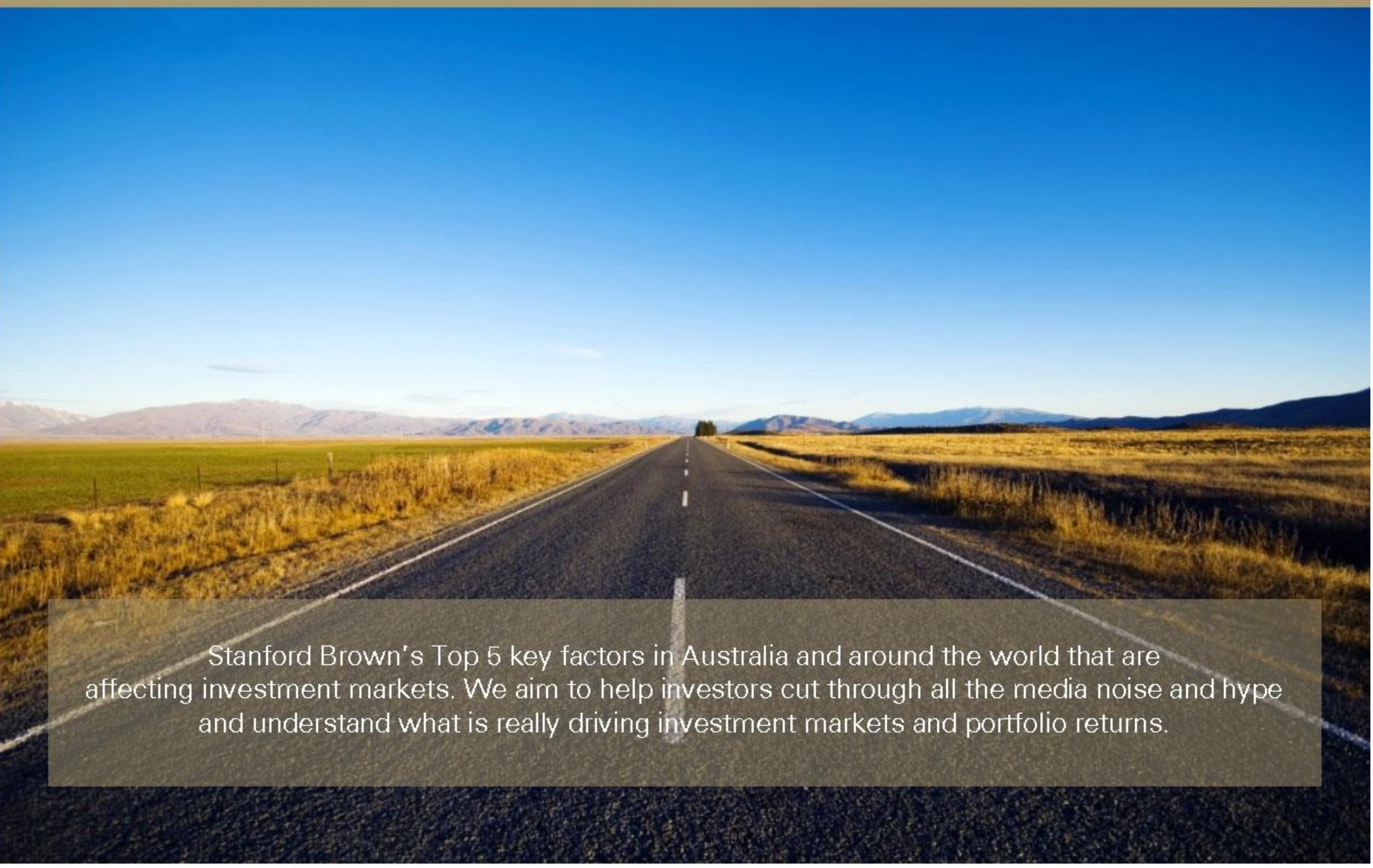
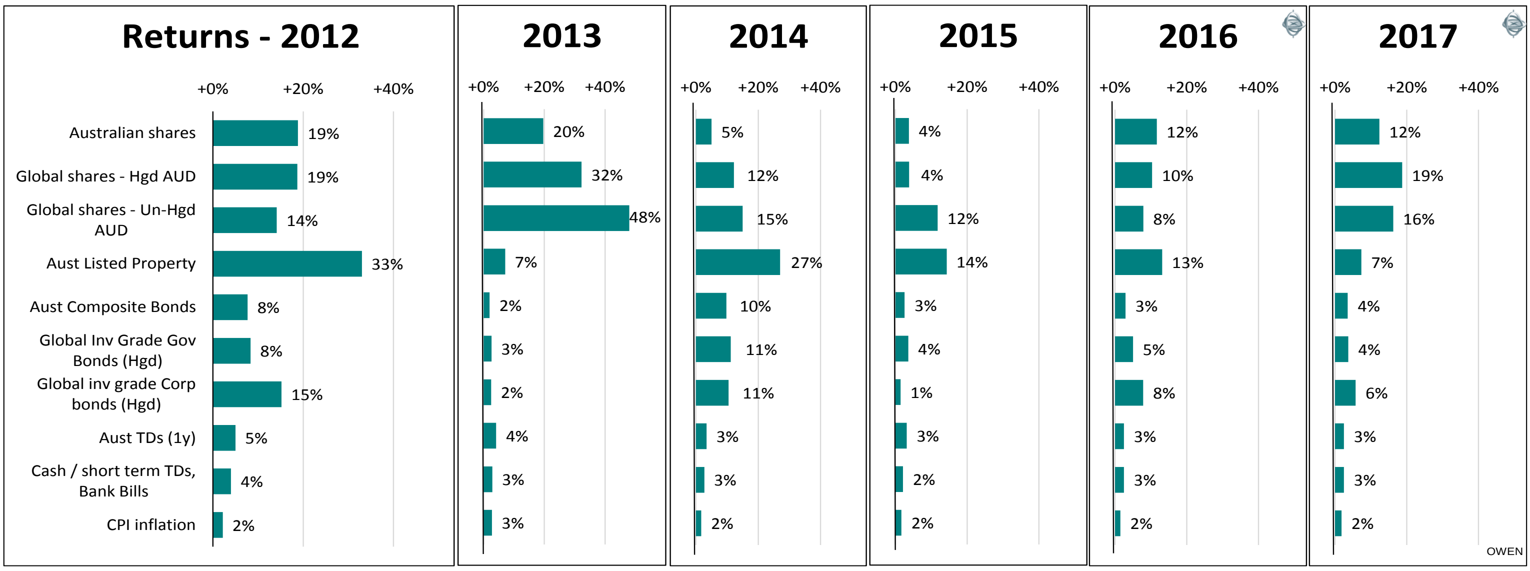


Stanford Brown's Top 5 key factors in Australia and around the world that are affecting investment markets. We aim to help investors cut through all the media noise and hype and understand what is really driving investment markets and portfolio returns.

1 Better than as good as it gets!

2017 goes down in history as the 6th consecutive year of positive real returns from all major asset classes for Australian investors – Australian shares, global shares, Australian and global bonds, listed and unlisted commercial property, housing and even bank deposits (just). Six straight years when everything went up has never happened before in history. Not a drop of red anywhere:



The next longest period was 4 positive years in 1925-28 – the great post-war housing and government spending boom. (No prizes for what happened next: the 1929 crash, 1930s depression and defaults by NSW and Commonwealth governments).

There were also 3 instances of 2 consecutive years of positive real returns from all asset classes:

- **1944&5** – Soviet defeat of Hitler, D-Day, German/Japanese surrenders
- **1997&8** – global 'dot-com' boom, Telstra T1 & AMP floats, Asian currency crisis, Russian default, LTCM collapse
- **2003&4** – kicked off by the Iraq War, the start of the 2003-7 China/mining/credit boom, interest rate hikes

In addition there were also 12 individual years of positive real returns from major asset classes: 1900, 1904, 1906, 1920, 1923, 1931, 1954, 1963, 1986, 1991, 1993 and 1995. All up that's a total of 28 years since 1900 when everything went up. Not bad.

On the other hand, periods of ***negative*** real returns from the major asset classes together are relatively rare and short-lived. The longest period of negative real returns from the major asset classes was just 2 years:

- **1951&2** – with the Korean War inflation, tax hikes, savage budget tightening, collapse of the wool boom.

There were just 4 individual years where major asset classes posted negative returns together:

- **1912** –War build-up in Europe, US dismantling the Money Trusts, Titanic sinking
- **1941** - Hitler invading Russia, Pearl Harbour bombing, Japanese army storming down through Asia.
- **1948** – Industrial unrest, communist agitators, Australian bank nationalisation crisis, Soviet blockade of Berlin
- **1973** – Aust monetary tightening, severe credit squeeze, Britain entering ECM, USD devaluation, Yom Kippur oil crisis

What is the common thread that runs through all of these positive and negative return periods? Inflation.

Each of the periods of across-the-board ***negative*** real returns had ***high*** inflation. Australian CPI inflation ran at 19% and 17% in 1951 & 52, 11% in 1912, 5% in 1941 (restrained by war-time price controls), 10% in 1948, and 9% in 1973.

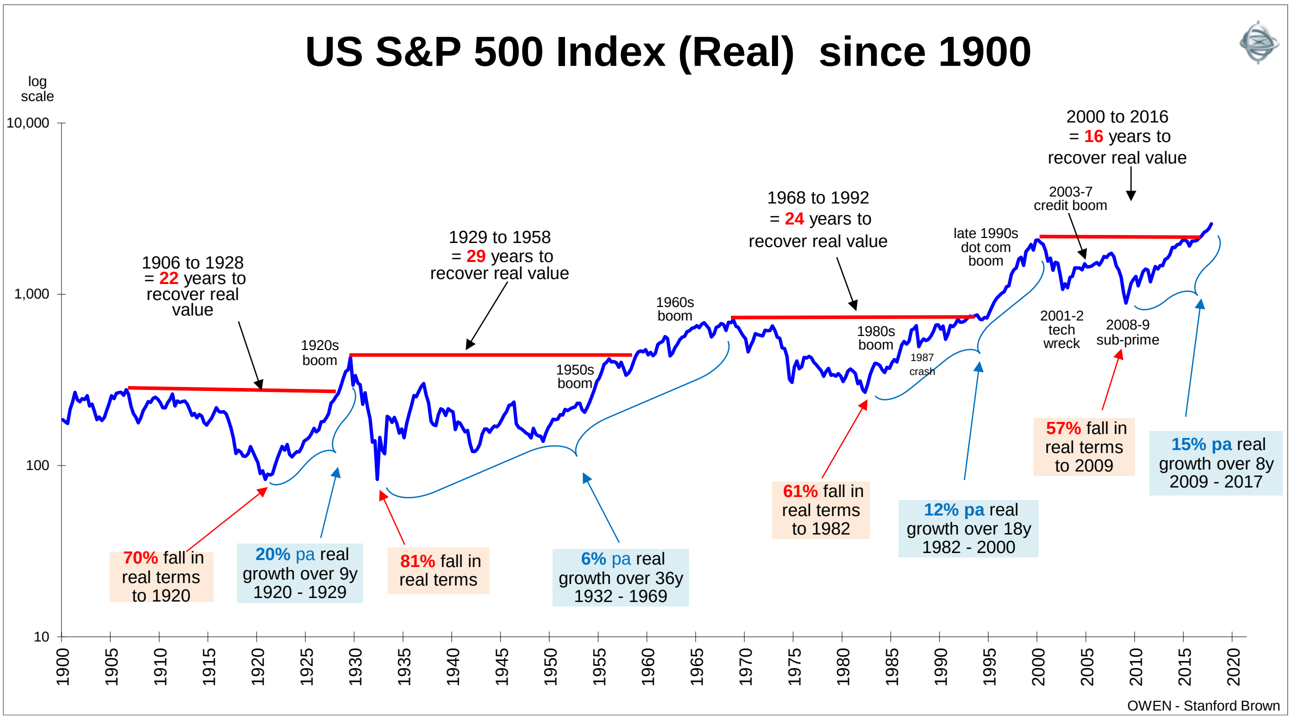
Conversely, each of the periods of across-the-board ***positive*** real returns had ***low*** inflation, including the current 6 year rally.

Will markets remain positive for another year to make it 7 years in a row? All types of assets everywhere are expensive, but shares, property and bonds all tend to do well when inflation and interest rates are low. The good news is that inflation and interest rates are still very low in Australia and around the world and are likely to remain that way for some time yet.

2 Have US shares run up too far?

US shares posted another strong year of gains in 2017. The S&P500 index is up 20% in price terms and 22% including dividends for the year. Since the GFC low on 9 March 2009 the price index is up a total of 300% and the total return index including dividends is up 400%. It has been a fantastic bull run lasting nearly 9 years so far. This has led to numerous queries from investors: - Has the boom been running too long? Has it been too steep? Surely after 9 years it must collapse?

The answer is 'No'. The chart shows real (after inflation) total returns (including dividends) from the US S&P index since 1900.



The current 9 year upswing is not that long compared to previous cycles. After the 1929 crash the market rallied by an average of 6% pa in real total return terms for 36 years between 1932 and 1968 when the 1960s auto & aerospace boom ended. It was milder than the current rally, and it had some bumps along the way but 36 years was a very long rally indeed.

Also the 18 year rally from 1982 (in the depths of the Volcker inflation-busting double-dip recession) to the top of the late 1990s 'dot com' boom generated an average 12% real total returns per year for 18 years. One of the bumps along the way was the 1987 crash, which much milder in the US than it was in Australia. You can hardly spot the 1987 crash on the above chart.

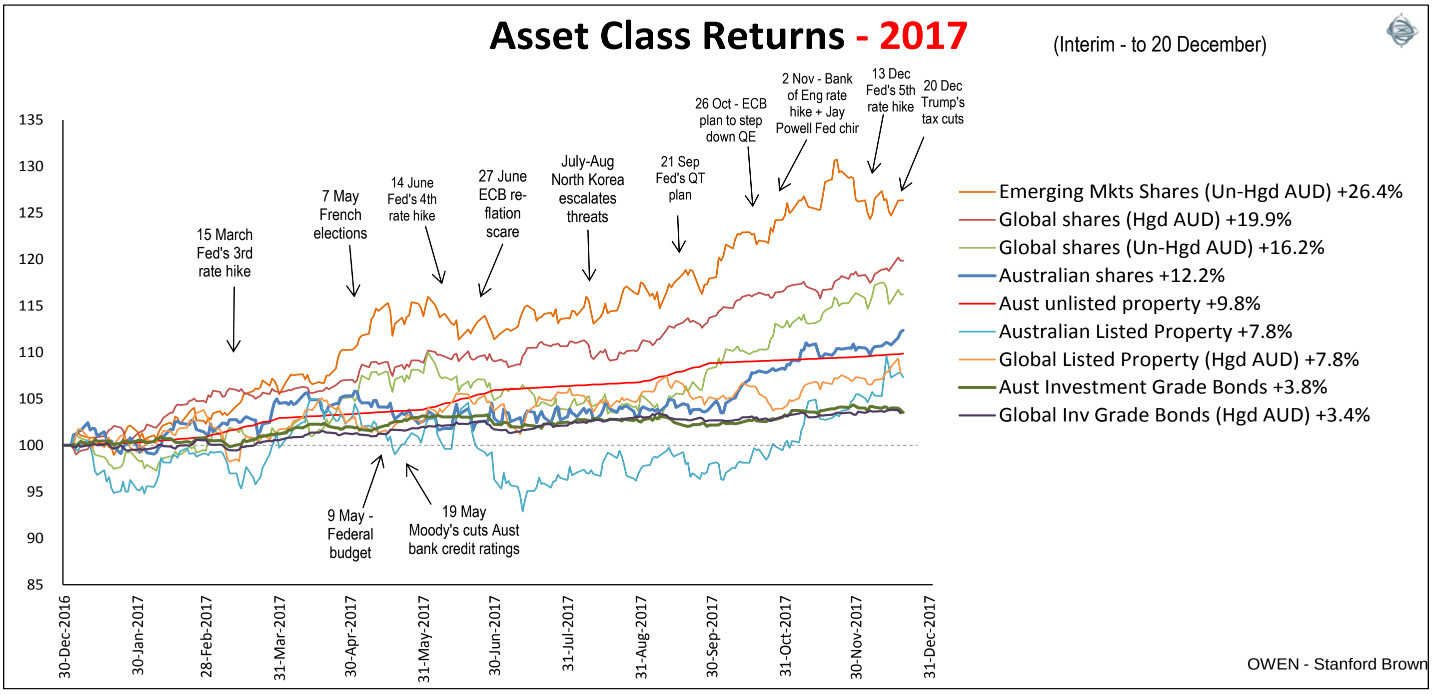
What also stands out is that the 57% real fall during the combined 2001-2 'tech wreck' and 2008-9 GFC crash was actually the shallowest of the major falls in the US market. It was shallower than the 70% fall from 1906 (prior to the 'panic of 1907) to 1920. It was also shallower than the 81% fall from 1929 to 1932, and shallower than the 61% fall from 1968 to 1982. So the 2008-9 GFC sell-off - even when added on top of the 2001-2 'tech wreck' – was not a 'once in a century' crash at all. The US market has suffered longer and deeper falls in the past.

The current 9 year rally has been strong enough to lift the real total return index back up above its dot com boom high – but it took 16 years to do it. This seems a long time to recover from a major sell-off, but 16 years is actually quite a bit shorter than the recovery times from the last 3 big sell-offs. The market took 22 years to recover the falls following the 1906 high, 29 years to recover from falls following the 1929 high, and 24 years to recover from the falls after the 1968 high.

This does not mean the US market is not over-priced and vulnerable. It is. But the current 9 year rally is not unusual or unprecedented. The US economy is on a very slow recovery cycle: 5 years of zero interest rates, 'QE' asset buying and trillion dollar government deficits, followed by 4 years so far of very slow fiscal and monetary tightening. Even after 5 Fed rate hikes, rates are still very low, the Fed balance sheet is still bloated and fiscal policy is still very stimulatory. The slow economic recovery has a long way to go yet before runaway inflation needs to be countered with restrictive monetary and fiscal policies.

3 Portfolios and lessons in 2017

With each of the main asset classes posting positive returns in 2017 it was pretty hard to lose money. Having said that, each of our dynamically managed model portfolios ('Conservative', 'Moderate', 'Balanced', 'Growth' and 'High Growth') beat their peer multi-sector funds in the market. They also exceeded their long term 'inflation-plus' targets and their expected long term average returns (full year results will be available in January) Not bad for the 6th year of the supposed 'new new normal' in a so-called 'low return world'!



We added value to portfolio returns in two main ways – (a) active asset allocation and (b) active fund selection.

(a) Active asset allocation means taking positions on various asset classes (shares, bonds, property, etc) that are different from our 'neutral' or passive weights - eg over-weighting shares. It includes taking active positions on various sectors within the asset classes - eg. over-weighting or under-weighting a particular sector or region within Australian or global shares asset classes.

While all portfolios were neutral on their overall growth/defensive mix this year, we did take a number of active positions in portfolios and each of them added value. The active positions we took in portfolios were:

- In Australian shares - bias toward small/medium versus large companies – paid off as the big banks dragged on the market
- In global shares - over-weighting 'emerging markets' shares – paid off as Chinese tech stocks in particular were very strong
- In global shares – bias toward hedged versus un-hedged as we believed the AUD would rise – paid off as the AUD rose
- Within defensive allocations - bias toward floating versus fixed rate – neutral: fixed and floating rates remained low
- Within fixed rate bonds – bias toward corporate versus government bonds – paid off as credit spreads contracted

(b) Active fund selection within asset classes: More than 60% of the portfolios are made up of active funds and these added value as most of active funds we use beat the passive benchmarks for their asset class. This is harder than it seems because the vast majority of managed funds in Australia and around the world fail to beat their passive benchmarks after fees.

As far as regrets go, it is easy to look back with the benefit of hindsight and say (for example): "we should have had more global shares". The problem was it very hard to argue for an over-weighting to global shares when they were so expensive at the start and with the Brexit vote and Trump election so fresh in the minds of our investors. As it turned out our commitment to shares was the main reason we beat most other multi-sector funds in the market because they were under-weight global shares (in particular US shares).

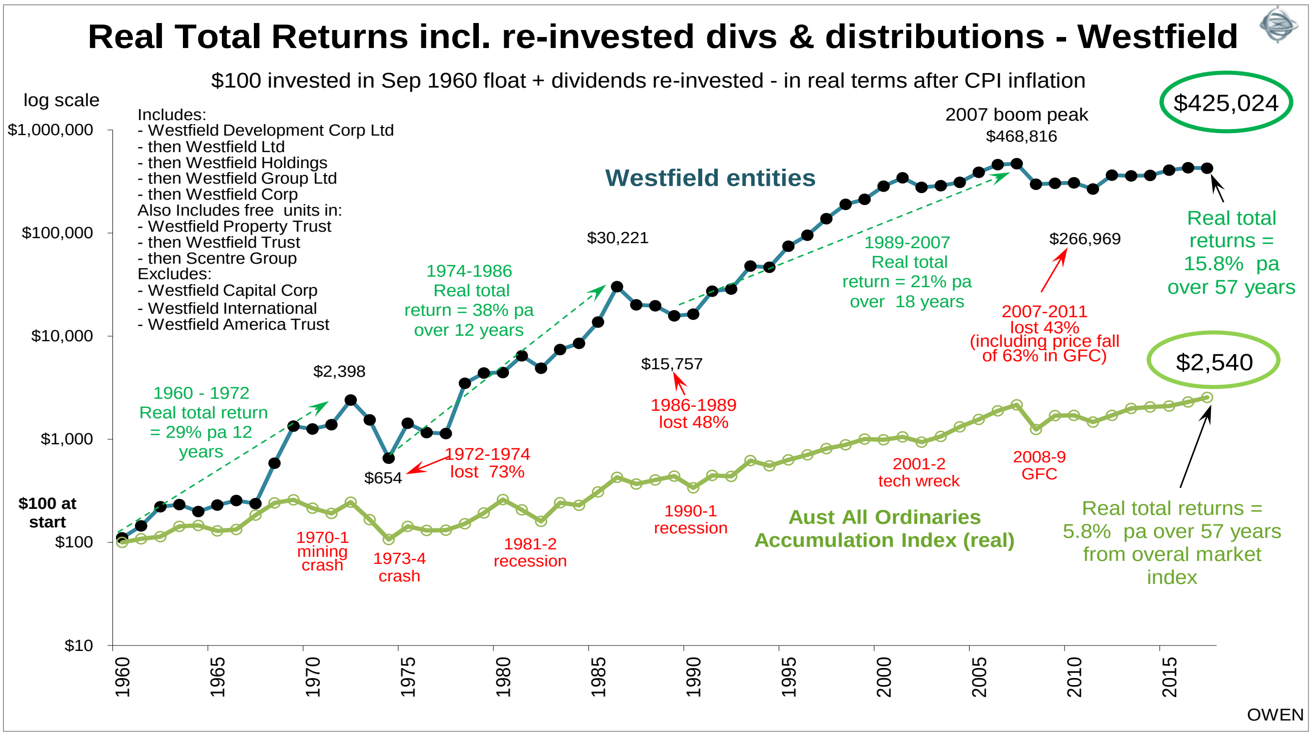
Where our process really adds value (both in asset allocation and in fund selection) is in years when asset classes don't all go up (which is most years historically). Bring on next year!

4 Frank Lowy's excellent adventure

2017 marks the end of the careers of two of the great Aussie business builders – Frank Lowy and Rupert Murdoch. Here we focus on Lowy's Westfield. Young Czech immigrant Frank Lowy started building shopping malls in suburban Sydney in the 1950s and this month he finally sold out his global shopping mall empire to French group Unibail-Rodamco in a deal worth some $20b (and that doesn't include another $20b worth of Australian and NZ shopping centres which are now in Scentre Group). It has been a remarkable career of great vision, determination, dogged perseverance and sheer hard work.

It has also been extremely profitable for investors who stuck with him over the long haul. An investor who bought the equivalent of $100 worth of 5 shilling shares in Westfield's September 1960 float and hung on to them through all of the restructures, reinvested all of the distributions and retained the spin-offs, would have made an incredible $425,000 in real (after inflation) terms for every $100 invested! That's a real return of 15.8% per year over 57 years. Unfortunately there are probably only 2 people who still hold their original 1960 shares – Frank and possibly the family of his original business partner John Saunders.

The Westfield corporate structure is one of the more complex I have come across but I have followed it, and was a shareholder, for many years. The chart shows total returns (including reinvested dividends and distributions) in real terms (after inflation) from the original float right through all of the various entities - which include 5 main companies and 3 main trusts. I have also showed real total returns from the broad All Ordinaries index (in green) over the same period for comparison.



I have learned many lessons from the experience. One key lesson is to follow the Lowy money – which means sticking with the property development companies rather than the retail trusts. The passive Westfield property trusts have provided adequate returns over the years, but nothing like the explosive growth of the main Westfield development companies. Another lesson – which is common to many of the great business builders – is to stick to the knitting. Frank got caught up from time to time buying all sorts of things from TV stations to oil pipelines and lost money every time he diversified from his core business. He failed in the US twice before finally succeeding on his third attempt. The combined share price of what is now Westfield (WFD) and Scentre (SCG) are still only half what they were 10 years ago, but that is more a function of the crazy bubble prices in 2007 compared to the more sober overall market pricing today.

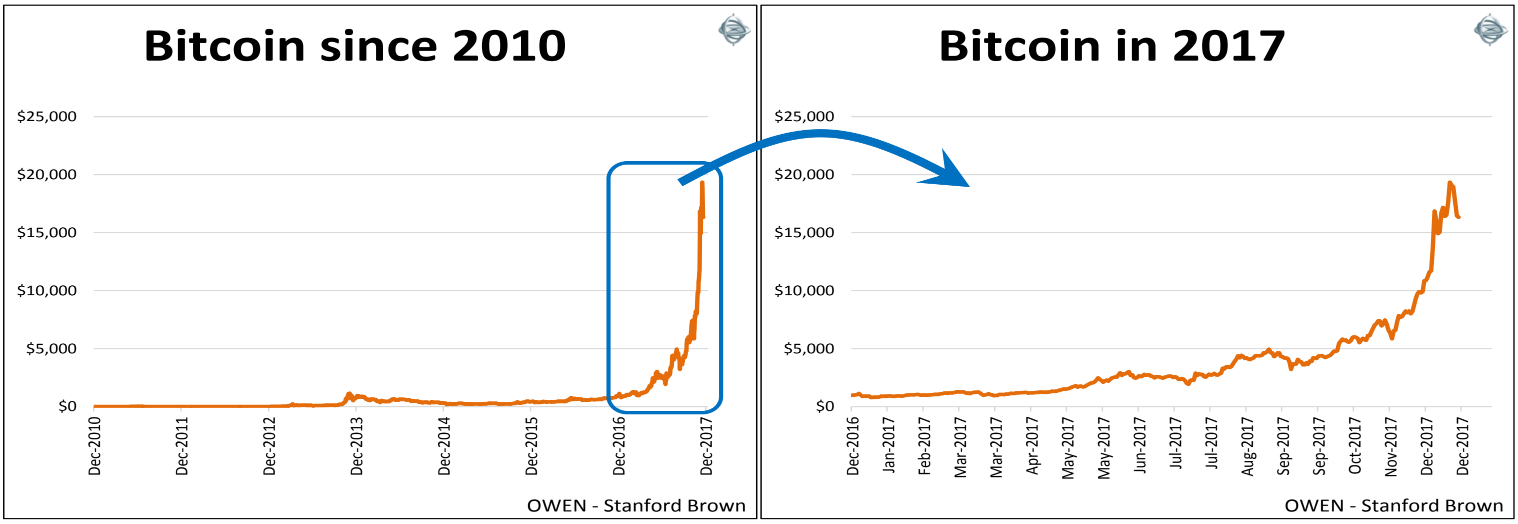
Another lesson is to follow the Lowy money when he has chosen to exit. It is now 10 years since Westfield peaked. Shopping malls were the great 'disrupters' in the 2nd half of the 20th century but they are now are being hurt by new disrupters – online shopping and smart phones. Frank stuck to his knitting, but that will not provide the same great returns in future so he has taken a well-earned bow. Congratulations and thank you. Will we see the likes of Frank Lowy again? Of course – they will be among the new breed of disrupters.

5 Bitcoin - logic and emotion

Over the past year there is probably only one topic that has captured more attention from investors, journalists and bloggers in Australia and around the world than Donald Trump – and that is Bitcoin.

Although Bitcoin has been around since 2009 it really took off in 2017 when the price rose from less than $1,000 USD to nearly $20,000. There have been ups and downs along the way including a 20% drop over the past week. The price rise has created several billionaires (including one Australian) and countless millionaires. Is it a new ‘currency’ or is it just another bubble?

Plenty has been written on the subject already (including by me) and I will not attempt to summarise all the arguments here. Most of my attention is on how people react emotionally or logically to the phenomenon.



The usual difference between ‘investment’ and ‘speculation’ is that with an investment you can put a value on it based on your estimate of the net present value of its expected future cash flows. With any given asset, different people can have different expectations about likely future cash flows from it and they can use different discount rates (to account for inflation and risk), and so different people can place different values on the same asset. On the other hand with speculation there are usually no realistic expectations of cash flows, just the hope that one day you can sell it to a ‘bigger fool’ (the ‘bigger fool’ theory).

This discounted future cash flow idea is a good way of valuing most investments but not all. For example I am a long term holder of Warren Buffett’s Berkshire Hathaway but it has never paid a dividend and never plans to in the future. But even without any expectation of future cash flows it has been an outstanding investment for many decades, because there has always been someone willing to pay more for Warren Buffett’s outstanding assets and skills. Likewise with Amazon.

Bitcoin is unlike Berkshire or Amazon but it is not entirely without merit. Like most speculative bubbles there are aspects that have substance. The positives are that it has a pre-determined and limited supply (like gold, but better than paper currencies). It uses ‘Block chain’ to record and store transactions without the need for intermediaries (like banks) or governments. Block chain is a legitimate phenomenon which is increasingly being utilised by major companies, banks and even the ASX.

On the other hand there major problems. The first is that Bitcoin is not a currency yet because it tends to be hoarded rather than used to buy and sell things. There have been notable examples of people advertising items (including houses) where the sellers are willing to accept payment in Bitcoin from the buyers. But it has not been the other way around – nobody wants to use their precious Bitcoin to pay for items yet – they would much rather hoard it in the hope the price rises even more. Then when the Bitcoin price starts falling, nobody will want to accept it as payment for anything. So it certainly not a currency yet.

Aside from losses from price falls, the reason many thousands of people have lost money is when their Bitcoins have been stolen by hackers breaking into the Bitcoin exchanges. Take housing as an example - when you buy or sell your house you trust your lawyer and your bank with the title deed. If either the bank, the lawyer or titles office staff steal your title deed you can always get a duplicate title issued by the titles office (and you can sue the lawyer or bank – both have indemnity insurance to cover it). But with Bitcoin - every day hackers are stealing the ‘personal key’ to Bitcoins that people have given to the Bitcoin exchanges to complete transactions. When the personal key is stolen you have no recourse to any government, and the Bitcoin exchanges can’t issue new Bitcoin because the supply is strictly limited.

Bitcoin . . . . emotion in decision-making

Instead Bitcoin exchanges have to had to buy Bitcoin on the market (or worse still, borrow to buy) – which pushes the price up even further - in order to compensate victims of hacker thefts. Some exchanges have issued pseudo crypto currencies to compensate victims of hacker thefts, but these have tended to create a whole new set of problems of their own. The most likely cause of a meltdown and general price collapse of Bitcoin would be the failure or one or more of the major Bitcoin exchanges. The largest exchange, Bitfinex, is currently in the midst of such problems with its 'Tether' compensation crypto it issued to cover hacker thefts.

All of these are the types of factors a logical person would weight up before making a logical decision to buy or sell. The problem is that bubbles and busts are not mainly about logic, they are about emotion.

For the emotional side of making decisions about Bitcoin (or any other asset for that matter) we will look at a real live case study. One of the young staff in the office here in his early 20s spent $1,000 buying Bitcoin at $230 in late 2015. The initial $1,000 has turned into $75,000 today. Not a bad effort for a young grad! But what should he do now?

Should he sell the lot now because the price has risen by so much it cannot be expected to rise much further? The problem with that advice is that they would have said 'sell' as the price rose all the way over the past 2 years. If he listened to that advice he would have sold out when the price doubled or trebled and he would have not made the additional $70k he has now.

Or should he hold on? The Bitcoin phenomenon is still gathering global support and is likely to last for at least a little longer, and has a good chance of going higher still. It was a pure punt initially, so why change now?

Where should you set a price target to sell? $20k per Bitcoin? $25k? Why not $50k or $100k? The problem with price targets is that they always have to be moved. When he bought for $230 a sensible sell target might have been $500 or maybe $1,000. Whatever it was initially it would have been triggered long ago and he would never have made the $75k.

Should he set a 'stop loss' (a price at which the stake is sold to prevent losses from further falls)? At what price?

Or should he sell $1,000 now to recover the initial investment so anything above that is pure profit? The problem here is if he did that when his stake was worth say $2,000 (logically not a bad plan after doubling his money), then he would have missed out on half of the entire gain since then.

Perhaps he should sell say half, to a least lock in half of the money (or less after tax) as 'real' cash? Same problem as above.

Alternatively should he set a calendar target? He could say something like – it's been a fantastic run and I would be happy selling out at whatever the price is on (say) the end of December 2017. The date might be arbitrary or it could be linked to an event – like using the cash to buy a trip or a car or deposit on a house (now there's another emotional decision – a house!).

If he does sell some or all of it – what should he do with the proceeds? Surely not sit on cash – the lousy income from cash is fully taxable and the capital goes backward after inflation. Since he is in his early 20s with virtually no expenses, no commitments and no need for the cash – he should probably use a highly aggressive asset allocation. That might include . . . dare I say it . . . speculation in things like . . . . Bitcoin! (surely not!)

Should he buy more on the recent 20% dip? 'Buying on dips' is one of the great success strategies for gaining more exposure to something you already hold. If you are happy to hold something at a given price and not sell, then why would not want to have more of it? Conversely, if you would rather not hold more of it, then that is a sign that you probably would rather sell if you had to make a decision. He is probably kicking himself for not buying more initially ('If only …!), so he can rectify that now, given the gathering global interest that will probably propel the price even further. Given past history the recent 20% dip is probably just a temporary blip. He thought about it when the price had risen to $500 but didn't buy more because the price rises might not continue. Then he thought about it again when the price had risen to $1,000 but didn't buy more because the price rises might not continue. Then he thought about it again when the price had risen to $2,000 but didn't buy more then because the price rises might not continue. At what point is it too late?

Or should he borrow to buy more? Don't laugh! Usually at the top of a bubble frenzy people start doing crazy things like borrowing to buy into a rising price. Sadly I know of plenty of people who borrowed to buy into things like ABC Learning, Babcock & Brown, Slater & Gordon, Centro and dozens of hot dot-com stocks in the 1990s dot-com boom. (Only once in my life have I ever recommended people borrow to buy shares and that was in March 2009 – but that was at the very bottom of the GFC – the exact opposite of a bubble. It was hard enough to convince anybody to buy anything, let alone borrow).

These are the same real decisions that face anyone who owns assets (speculators and investors). Most decisions we make in our lives are emotional more than they are logical. Learning to manage emotions is the most difficult part of investing.

Meanwhile I am happy to watch from the sidelines. (ps. Berkshire Hathaway shares hit $300,000 (USD) per share this week!).

What lies ahead?

It would be too much to ask for a seventh consecutive year when everything goes up. 2017 was a bit lucky because Australian shares and listed property trusts were flat all year until they suddenly jumped in October. Also bonds barely beat inflation.

The problem is that assets are expensive virtually everywhere you look in the world. In the case of shares, the good news is that company profits and dividends have also risen strongly during the year, meaning the level of over-pricing relative to earnings and dividends is no more stretched than it was last year. The bad news is that most of the increases in profits and dividends in 2017 in Australia and around the world were merely recoveries of the losses and dividend cuts in 2015-6 that were caused by the 2014-5 commodities price collapse in 2014-5. The scope for Australian companies to grow top line sales and bottom line earnings is limited, but most of the opportunities for growth are in international markets.

Investment returns in 2017 were driven by developments in the three big global markets – US, China and Europe. In the US, Donald Trump managed to stumble and bumble his way to two major stimulatory measures – increases in defence spending and the long-awaited tax cuts. The US economy has continued to gather pace and the Fed has kept its foot very lightly on the brake pedal with the 3rd, 4th and 5th rate hikes. This forward momentum and confidence will probably continue into next year.

As with the US, in China it has also been mainly about one man more and to a lesser extent the economy. It was our view all year that Xi Jinping was going to need to keep the economy growing steadily via government-directed stimulus measures while he removed competitors and cemented (or concreted rather) his political power base. He has visions for himself that extend beyond just a couple of 5 year terms accorded to his immediate predecessors. He genuinely sees himself as the next Mao and Deng and has built an unchallenged one-man state in the style of Mao and Stalin. It will take a revolution to remove him.

What is new is that his visions for the economy and foreign policy go far beyond those of Mao and Deng. China's post-revolutionary vision was merely to rid itself of foreign overlords and restore China's independence and dignity. A thousand years ago China and India were together the largest economies with the richest populations in the world. Then they both allowed themselves to be humbled and humiliated by foreign colonial powers – Britain in the case of India, and no less than 8 different foreign powers in the case of China. As a result China and India were reduced to being the poorest countries in the world by the middle of the 20th century. Mao and Deng wished only for China to stand up for itself and end the humiliation. Mao led the revolution but his communist experiments were disasters, but Deng started China 'down the capitalist road' and kicked off the massive industrialisation and urbanisation boom that has brought it so where it is today.

Xi is now taking it much further. He has grand visions of building a colonial empire of his own across Asia and into Europe and Africa under the 'One Belt One Road' banner, and building a huge military force to rival and one day surpass and defeat the US. This is good for investors for two main reasons – the first is that Xi is likely to retain stimulus spending (which should support commodities prices and domestic and international demand for goods and services), and the second is that military build-ups create global demand and also inflation, which is something central bankers have been dreaming about in vain for 9 years.

The third major region is Europe. Despite the unstoppable and inevitable political fragmentation both within and between countries, economic activity across Europe has finally shown signs of sustainable recovery. Unemployment rates have kept falling and inflation is finally appearing, first in demand and prices, and probably soon in wages. The early small problem countries (Ireland and Iceland) took their medicine early and recovered first, and now the larger problem countries (like Spain and Italy) are showing some signs of revival. Even the utterly unreformable France is starting to look positive under Macron.

I have tried to avoid talking about Australia. Over the past year every time I meet an American they start by apologising for Trump to try to stave off the inevitable Trump jokes. However over the past 6 months I have also had to apologise for our politicians because Australia now has become a laughing stock around the world – yes, worse than Trump! - thanks to the ridiculous dual citizenship debacle made worse by all of the lies and cover-ups. That's probably all I should say about Australia!

'Till next time, happy investing. Have a wonderful holiday season and a happy new year!

Ashley Owen, CFA
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