UNCONVENTIONAL WISDOM

Unique investor insights from Wattle Partners

October 2020

The month that was...

BIDEN HARRIS
BIDEN HARRIS

- As this issue goes to print it has become clear that Joe Biden will be the new President of the United States. Despite protestations from the incumbent President Trump the votes are clearly swaying in the favour of the Democrats, albeit not at the level predicted. Once again, it is the pollsters and media focused on predicting the outcome and 'race' that have been found out with predictions of a 'Blue Wave' not coming to fruition to the level expected. Magellan Financial Group CEO, Hamish Douglass, has described what looks to be the end result, a Republican Senate but Democrat President, as 'Nirvana' for sharemarkets. This is because the Democrats are unlikely to have sufficient power to repeal the Trump tax cuts, nor embark on their 'transformative' agenda. At the same time, the trade rhetoric will likely abate. It is for this reason that global sharemarkets have been positive in the early stages.

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- The Reserve Bank of Australia's (RBA) Cup Day decision to commence quantitative easing will be marked in history, the first such time the central bank has done so in Australia. To summarise, the RBA announced that the Overnight Cash Rate would be cut from 0.25% to 0.1%, the target yield for the 3-Year Government bond rate would be lowered to 0.1% and they would commence buying $5 billion per week of 5- and 10-Year Bonds for the next six months. The purpose was abundantly clear from the Governor's statement with the stubbornly high Australian dollar holding back an economic recovery, due primarily to our 'high' bond yields of 0.8%. The secondary benefits are a fall in borrowing and savings rates with both consumers and investors forced to spend.

- The story of October for sharemarkets will be twofold, the boom in Initial Public Offerings (IPOs) and more importantly takeover activity. Australia's performance in combatting COVID-19 has made it an attractive home for private equity and other major businesses, and with borrowing rates around the world as low as 2-3%, 'boring' companies growing revenue as slowly as 4-5% can be attractive options. October saw takeover offers from a number of stable, but unloved businesses ranging from Coca-Cola Amatil (ASX:CCL), Link Administration Services (ASX:LNK), AMP Ltd (ASX:AMP), Janus Henderson (ASX:JHG) and more recently Evans & Dixon (ASX:ED1). What Australia lacks in technology companies may be compensated by our slow growing old-fashioned businesses which may just be popular again.

- The IPO market showed signs of getting out of control during the month, with a broad range of business heading to the ASX boards. Basically, any company with an association to e-commerce, cloud computing, technology or buy-now-pay-later was in high demand on the back of strong revenue growth throughout 2020. In fact, many businesses that struggled to raise far less capital just 12 months ago are now seeking much larger amounts following an unexpected boom. Most IPOs performed well on listing, primarily at the expense of remaining investors, however the market showed signs of slowing as the month came to a close. For example Zebit (ASX:ZBT), a BNPL provider, fell over 30% on its first day of listing, Adore Beauty (ASX:ABY) is down over 15% in just a few weeks. As always, buyer beware, and make sure the CEO isn't selling into the offer.

- Looking around the world the first signs of improvement are feeding through after the first wave of lockdowns hit the first and second quarter GDP results. The US economy rebounded at an annualized rate of over 33% in the September quarter meaning it is only slightly below the pre-COVID economy. Similarly, China continues to lead the world (but particularly Australia) out of the malaise, growing 4.9%, with consumer spending an important contributor. As highlighted by recent pressure on a number of Australian export industries China announced it will be targeting greater 'self-sufficiency' in technology and a number of other areas. This is likely to be a theme of the next few years which may ultimately be inflationary.

- Concerns of a bubble in technology stocks continue to take headlines but the companies themselves continue to deliver. Apple Inc. announced a 20% fall in iPhone sales but revenue slightly ahead of estimates at $64.7 billion for the quarter. Accessories, including the Air Pods remain the key growth driver, up 20.8%. Amazon Inc. (NASDAQ:AMZN) offered a more mixed result, with the cloud computing division up 29% and revenue slightly ahead of expectations at $96.1 billion for the quarter. CEO Jeff Bezos did however flag higher costs and shrinking margins as COVID-related costs hit earnings. Alphabet Inc, (NASDAQ:GOOGL) was the winner of the day, reporting revenue of $46.2 billion driven primarily by its booming YouTube division where ad sales grew 32% as the world turned digital during the pandemic. As discussed in our podcast with Nick Griffin of Munro Partners, now is the time to remain active in the sector.

- As highlighted in recent issues, divergence in every aspect of investment markets remains at heightened levels and more than ever, the sharemarket does not represent the real economy. It is clear that the pandemic recession will hit smaller business far worse than larger, cashed up businesses with many consumers opting for the safe and lower cost options despite an improving economy. In October it was the IT (+8.9%) and Financials (+6.3%) sectors leading the way. Looking more closely though, the financials sector remains 25% below its 2019 levels, with energy, down 42%, and property, -21%, still yet to show signs of recovery. These sectors should all be part of an eventual 'recovery portfolio' but without real progress on a vaccine they are simply hopeful at the current time.

- One of the most powerful themes of the month was clearly ‘governance’. The G in ESG has come to the fore with the resignation of Australia Post’s CEO a major scalp in recent weeks. Staying with the public service, the financial regulator ASIC lost a number of high-profile staff members placing even more pressure on the unit. On the ASX, it was Magellan Financial Group (ASX:MFG) and Crown Ltd (ASX:CWN) facing the brunt of shareholders. MFG was pressured following a number of investments made with shareholder capital, including into the investment bank Barrenjoey, whilst CWN faced an inquiry over long standing business practices. This is without flagging those businesses that paid executive bonuses after receiving Job Keeper payments during 2020.

- Whilst the feeling in Australia could almost be described as jubilant, when we look to Europe and the US, we see the worst of the virus spreading again, with cases and deaths spiraling and lockdowns once again in place. This is once again showing how delicately poised the global economy is today and why central bank policy is more important than ever. The obsession with budget surpluses has seemingly been removed, to the benefit of the people, as government seek to avoid a fully-fledged depression and ballooning unemployment. It is clear that a Government deficit actually means they are contributing more capital to an economy than what they are taking out via taxes and penalties. The alternative, of removing capital from an economy at a time of need, like today, simply makes little sense; hence the thus far bipartisan support for fiscal stimulus.

Model Portfolio Update

- Investment Committee -

Index	Index Points - September	Index Points - October	Performance 1 Month	Performance 1 Year
S&P/ASX 200	5815.9	5927.6	1.9%	-11.0%
All Ordinaries	6009.3	6133.2	2.1%	-9.4%
US Dow Jones	27781.7	26501.6	-4.6%	-2.0%
US S&P 500	3363.0	3269.9	-2.8%	7.6%
Hang Seng (HK)	23459.1	24107.4	2.8%	-10.4%
FTSE 100 (UK)	5866.1	5577.3	-4.9%	-23.1%
Nikkei 225	23185.1	22977.1	-0.9%	0.2%

Top 5 Performers	1 Month	Bottom 5 Performers	1 Month
Link Administration Holdings Ltd	27.9%	Ramsay Healthcare Ltd	-5.6%
AMP Limited	17.2%	BHP Group Ltd	-5.1%
ANZ Banking Group Ltd	9.2%	Telstra Corporation Ltd	-3.6%
Commonwealth Bank of Australia Ltd	8.5%	Aoris International Fund	-2.4%
Qube Holdings Ltd	6.9%	Magellan Infrastructure Fund	-1.6%

Sector	October	12 Months
A-REIT	-0.4%	-21.1%
Communications	-0.6%	-9.5%
Cons. Discretionary	1.3%	1.3%
Cons. Staples	4.8%	1.6%
Energy	-0.8%	-41.7%
Financials	6.3%	-24.6%
Healthcare	1.2%	11.6%
Industrials	-3.9%	-21.0%
IT	8.9%	44.5%
Materials	-1.2%	3.1%
Utilities	-1.5%	-17.5%

It was a mixed month for global sharemarkets in October, with the ASX seemingly taking the ascendancy over the faster growing US markets, the ASX200 finished 1.9% higher. The performance was driven by a rebound in the financials sector, with Victorian lockdowns ultimately proving successful and loan deferrals reducing as a result. It also benefited from the Federal Budget and key focus on supporting big business and employees.

It wasn't pretty globally, with most Northern Hemisphere markets hit by a combination of a disastrous COVID-19 second wave, economic lockdowns and the US presidential election. The broad MSCI World Index fell just 1.1%, whilst the big tech driven Nasdaq index took a breather falling -2.3% despite a strong period of quarterly earnings results. Europe was by far the major underperforming, with lockdowns in France, Spain and the UK sending both indices down 4.4% and 4.8% respectively. Despite the threat there are emerging opportunities in both regions.

The AUD has remained stubbornly high, trading around 70 cents despite the RBA specifically targeting a devaluation and bond rates remain all but unchanged.

The Wattle Partner's Balanced Growth Model Portfolio delivered another positive return in October, around 1.6%. This time performance was driven by the domestic equity exposure, with both Link Administration and AMP receiving takeover offers, whilst the banking sector showed signs of recovery as home loan repayment deferrals reduced substantially. The global equity exposures also performed well, led by the regional Asian exposure, via the Platinum Asia Fund, with the Chinese economy continuing to lead the way. The Model Portfolio was recently de-risked in light of the strong recovery since March and we are seeking new opportunities as the end of 2020 nears.

With interest rates near zero and dividend cuts seemingly across the board on the ASX, the days of expecting a 6% income or for income to meet the legislation minimum drawdown requirements are likely gone, with a focus on cash flow more important than ever. At Wattle Partners, we are applying a three-pronged approach, seeking higher income through credit and bond investments, undervalued companies via the ASX and growth overseas.

Award Winners

We also take the opportunity to congratulate a number of the fund managers entrusted within the Model Portfolio following the Zenith Research awards this week. The winners including GQG Partners, Munro Partners and Ausbil Investment Management, reflecting the high quality of active managers employed in your portfolio.

AMP Ltd (ASX:AMP): By far the news of the month was under pressure wealth manager, AMP Ltd (ASX:AMP) receiving a non-binding offer from Ares Capital to purchase 100% of the company. The news sent the share price 19.5% higher offering some validation to those who have seen value in the company's asset management and banking divisions. Management confirmed the offer but also highlighted that they have received significant interest in each of their businesses, with hopes of a bidding war to come. The buyers will undertake significant sue diligence but have initially valued the company at $1.85. As highlighted on various occasions, the individual assets of AMP were not being fully reflected in the share price, as a result of sentiment (deserved) offering an undervalued opportunity. We believe Ares is focused on the $200 billion AMP Capital business and would therefore be surprised if a potential bidder for AMP Bank or the group's Wealth Management division didn't come through in the weeks ahead.

Link Administration Services (ASX:LNK): I have highlighted the 'buyer's market' occurring on the ASX in my dailies and was therefore unsurprised that Link (ASX:LNK) received an unexpected takeover offer from private equity groups PEP and Carlyle Group at a price of $5.20 per share; shares rallied 25.1% as a result. The offer excludes the oft spoken about PEXA property settlement platform, with some shareholders already suggesting the offer 'undervalues' the business. With the company clearly in play, my view is to watch this space and look for an outright offer for the PEXA platform.

Seek Limited (ASX:SEK): SEK came under a highly publicised short attack from 'Blue Orca', an activist firm during the month. Shares were down as much as 11% before being halted down 5.7% for the day after it was claimed their Chinese job site was full of 'junk listings' that maintain the illusion of growth; strong words. That said, the business recorded revenue of $749.6 million in 2020 which cannot be easily fabricated. Management responded strongly, highlighting inaccuracies in the assertions made by 'Blue Orca' and flagging the strong increase in cash flow and cash balance of $222 million to confirm revenue had not been 'overstated'; shares fell just 0.8% after the trading halt was released..

Woolworths Ltd (ASX:WOW): Whilst technically coming after the end of the month Woolies delivered another strong quarter. Management announced this week 11.5% growth in same store sales at their supermarkets, with online sales the key driver double to reach 8% of sales in the quarter. Food sales continued to benefit from the Victorian lockdown, up 20% in the state alone, however, sales have slowed to around 8% in October has restrictions were released. Similarly, alcohol sales grew 20% after increasing 21.2% in the June quarter and even BIG W sales increase 22.3% despite closing 23 Victorian stores. The group has offset cost pressure from COVID-19 by investing into pick up and deliver capacity, driving the huge increase in online sales. Despite concerns that both WOW and WES would struggle to continue growing sales, they have managed to use the pandemic to tilt their businesses towards higher margin, e-commerce transactions, opening them up for a new leg of growth.

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Platinum Asia Fund (PLA0004AU): The fund performed exceptionally well growing 4.1% for the month and now 22% higher for the quarter as the Asian region solidified its ascendancy through strong control of the pandemic. China, Korea and Taiwan in particular have shown the rest of the world hold to deal with and move on from the economic shutdowns delivering solid economic growth and potentially pulling the global economy out of its recession alone. In our view, Asia remains one of the most attractive markets outside of the US due almost solely to the size of the opportunity afforded to businesses. The economies are growing more quickly, learning from the mistakes of others and in the case of China, welcoming more foreign investment as they seek greater internal self-sufficiency. The fund has a 45% exposure to China, 13% in Korea and 10% between Taiwan and India. The largest holdings are world leader Taiwan Semiconductors (TSMC), Samsung Electronics, Tencent and Alibaba Group, with the latter one of the best performing larger companies in the world in October.

Vanguard – The benevolent manager?

- Jamie Nemtsas -

Vanguard Group Inc. has drawn many headlines in recent weeks following its decision to 'give back' billions of dollars in investment mandates to Australian industry funds. According to Bloomberg reports the group has been implementing similar strategies in China and throughout the world.

The return or what some see as a refusal to continue with large investment mandates is a great headline but hides a deeper story that pervades the superannuation industry. For the uninitiated , an investment mandate refers to a contract between a fund manager, like Vanguard, to invest on behalf of a large financial institution (or financial adviser) based on an agreed, usually discounted, fee. It is this discount that is key.

Vanguard is an AUD $ 8.6 trillion global asset manager with the AUD $ 165 billion invested in Australia paltry in comparison to its global reach. So whilst the decision to cease running these mandates, which reports suggest may near AUD $ 100 billion of their Australian assets, will hurt income in the short-term, it will have limited impact on the group's overall profitability.

EXPENSIVE
CHEAP
CHOOSE WISELY

So, why do it?

It is simple, they don't get paid enough for it.

Recent reports have suggested that the fees paid by Australia's largest industry super funds can be as low as 3 or 4 basis points; that is 0.03 percent. For a worked example, if we assume Vanguard is paid 0.05 percent on an AUD$ 1 billion investment mandate, they will receive 'just' AUD $ 500,000 in investment management fees. There are two ways to compare this.

On the one hand, the pension and other large funds outsourcing their investment decisions to Vanguard will typically charge an investment fee of 0.5 percent or AUD $ 5 million on the same investment. They will then pay out $ 500,000 to Vanguard and keep the remainder for other investments, administration

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etc. At this point, it is worth pointing out that despite the expectation that pension funds are able to provide personal financial advice within this fee, this is generally very limited.

The second order issue relates to Vanguard's traditional business model, in that they offer services to three types of investors; retail or direct, wholesale, and institutional. As is commonplace, the fee charged to retail and wholesale investors is much higher than that charged to institutions, on average between 0.2 and 0.3 percent. So, in effect, Vanguard's direct investors have been subsidising the fees of large institutional investors for decades.

Again, using a worked example and the same investment amount, it would require just AUD $ 250 million in 'retail' money to replace the lost revenue for $ 1 billion in institutional mandates. Vanguard are effectively backing themselves in to achieve this; so all kudos to them. Another way to look at it is that Vanguard are turning a difficult situation into a marketing opportunity. They could, of course, have attempted to increase their fees to normalise their book, and risk losing these mandates to the lower cost players anyway.

A broader trend

The decision by Vanguard highlights a broader trend occurring in the superannuation and investment sector in Australia, one driven primarily by costs, size and internalisation. The recent budget announcements targeting underperform super funds is only likely to see this trend accelerate even further.

By no means am I suggesting that large corporate and industry funds are bad. They clearly plan an important role in guiding the retirement savings of millions of Australians and provided competition into a what was a bloated and uncompetitive sector for several decades. They are simply beginning to yield and use a substantial amount of market power. So much so that their customers are now becoming competitors. Vanguard has also launched their low-cost superannuation platform, Personal Investor.

As we have seen in the US super system, with size comes the potential to do more and to do more things in house. This internalisation, where pension funds run their own investment portfolios rather than outsourcing to fund managers, has been the driving force of consolidations in recent years. Traditionally, the strategy is to obtain a core index exposure, through someone like Vanguard, Blackrock or Amundi, as cheaply as possible, and then apply your own internal views and tilts as the Investment Committee sees fit.

The question which always rears its head in these situations, is how do you sack an internal investment manager if they underperform? But that is a story for another day.

What's an IPO?

- Amanda Bouzeid -

WHAT IS AN
IPO?

If you have been reading any financial media, or even social media, at all throughout 2020, you likely get the felling that the IPO market has been growing like crazy.

As a step back from the headlines, we thought it worth offering some insight into the IPO or initial public offering market and why so many companies are heading down this route. Despite the regular use of the term we have found many clients, investors and people in general may not fully understand its purpose or role in global capital markets.

So, what is an IPO?

Put simply, it is the process through which 'private' companies offer shares in their business to the general public. The general public is then able to buy and sell these shares via a registered stock exchange, like the ASX or New York Stock Exchange for example.

Why do companies IPO?

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Most companies IPO because they need more money. But this doesn't have to be a bad or a good thing. The purpose of an IPO is to expand the number of shareholders in a company and in effect offer that company access to other people's money in order to grow their business, acquire other businesses or in some cases buy out an existing shareholder.

A perfect example would be say a meal kit company which is currently producing 400k meals per day, but has demand for 1 million meals. In order to meet this demand they will require a new factory, but having invested every dollar of their money into the business, the shareholders need some additional capital to fund the expansion. In return for funding this expansion the shareholders than receive a share in the profits (and losses) of the company in perpetuity.

In most cases, companies seeking to IPO are growing quickly, need to make major investment or are even looking for some external support to assist in guiding their business. In other cases, they may be seeking to cash out, as in selling a share of a business they have spent years building to move onto something else.

How do companies IPO?

In general, most companies IPO through the most traditional route, engaging one or a number of stock broking firms to assist in finding investors to raise the amount of capital they require. This includes roadshows, presentations and constant pitches for investors with the wider the spread generally deemed as a better result.

The pricing of an IPO is then determined by a mixture of factors, but primarily the demand for the companies shares. It will be priced based on a comparison to similar businesses, both in Australia and around the world, and then each broking firm will undertake a 'bookbuild' through which bids are made for parcels of shares that ultimately determines the price.

Why don't all companies IPO?

The process of moving from a private to a public company is a complex and expensive one, hence it is not suited to every business. In fact, many fast-growing technology businesses prefer to stay unlisted in an effort to avoid the pressures that come with making all of your financial data public. Listing and then remaining on an exchange requires the constant and timely disclosure of all material factors relating to a company, a number of listing fees and an increased level of regulatory compliance.

What is a pre-IPO?

One of the fastest growing areas of the market in recent months has been the pre-IPO sector. This simply refers to companies that aren't quite ready to IPO and need some more money, and stronger growth, before they are 'ready' to IPO in say 12 months' time. These capital raisings are made into private companies, with less disclosure required, similarly facilitated by stock broking firms and are usually at a 20-30% discount to the eventual IPO listing price.

MSCI

- Drew Meredith -

While the active versus passive debate rolls on, and on, across the investment world, some active managers have gone to the 'dark side', at least partially, by adding more quantitative inputs for new strategies, such as thematic investing.

The concept of 'thematic' investing, which describes the strategy of identifying sectors of the economy expected to grow more quickly than others and usually over the medium-long term, has become mainstream. Yet, when we think about themes, some of us tend to be attracted to the most exciting ideas like Big Data, AI or autonomous vehicles, which are themes already playing out in market prices. In reality, some of the most powerful themes can be far more pedestrian and predictable.

Consider, for instance, the exchange traded fund (ETF) sector. This burgeoning global sector started

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the decade at just US$1.3 trillion in assets under management, but finished close to six times higher at US$6 trillion. Incredible growth for a market sector who has historically been predominantly passive, with active and smart-beta ETFs joining the party of late.

One of the most powerful strategies used to identify investment opportunities is not only to spot the trend but also to identify the companies that offer the infrastructure on which the trend is based. As they say, behind every good idea is someone clipping the ticket. So, while many focus on the trend, some smart investors focus on the 'clipper'. As an example, consider Amadeus IT (BME:AMS) the German group which facilitates airline, hotel and other travel bookings, across that sector.

But what about the investment sector itself? Enter MSCI Inc. (NYSE:MSCI) and its long-standing chairman, Henry A. Fernandez. MSCI (Morgan Stanley Capital International) was born in 1968 and headquartered in New York. The group was founded with a single goal to offer benchmarks or indices for capital markets outside of the US – the US obviously being the domain of Dow Jones and Co. In 1986, the group teamed up with Morgan Stanley, which became its largest shareholder and licenced the index, no doubt for an attractive fee. MSCI ultimately grew into the business it remains today, the leading ex-US index provider in the world, with a report by Burton-Taylor International Consulting suggesting a revenue market share of 25% In 2019.

It was with great skill, luck or timing, probably all three, that Morgan Stanley decided to divest and list the company on the NYSE at the absolute height of the GFC, trading for the first time in November 2007. What followed were years of doldrums, with a weak share price, poor earnings growth and any number of competitors entering the market from Eurostoxx to Standard and Poor's and Nasdaq.

Fast forward to today and the company is a US$25 billion behemoth that has grown close to 500 per cent in less than five years. In fact, despite the incredible weakness in the equity markets in the first half of 2020, the share price is up over 40 per cent for the year to date. The theme powering this trend is the incredible flood of capital into passive, smart beta and ETF strategies. Whether the result of pension funds focusing on lowering costs, the outspoken views of Warren Buffet and the late Jack Bogle, or the simple fact that many active managers tend to underperform their benchmarks, the theme is unquestionable.

The MSCI of today is far removed from the MSCI of the past, despite its CEO having led the company for more than two decades. The business has built the ultimate 'ticket clipping' machine while augmenting this through the power of its data collection capabilities. The most important part of the MSCI machine is its index business unit, which represents close to 60 per cent of sales.

Put simply, the company is paid a small amount – in some cases a percentage, in others a fixed fee – for every dollar under management that is guided by their suite of indices. Take iShares, for example: The group's popular MSCI EAFE ETF has more than US$350 million in assets under management, and tracks the MSCI EAFE index, with the ticket clipped. And iShares Japan, ticket clipped. In most markets outside of the US, including Australia which has had a late-blooming but rapidly growing ETF market, MSCI is a proven leader. Importantly, this revenue is recurring and regular, allowing the company to explore new and more exciting opportunities.

New opportunities include developing the company's analytical, risk management and data collection services. Tracking stock, bond and other market indices across the world requires an incredible amount of computing power which can handle a lot of unique transaction and trading data. MSCI is leveraging this capability through its 'portfolio analytics' unit, which counts the world's largest pension funds, hedge funds and other major investors as its most reliable clients.

Despite facing a headwind from falling markets in the first quarter, MSCI surprised with an outstanding performance in its data business, but specifically the ESG products. Management reported robust demand for the ESG ratings and climate change screening products, delivering annual equivalent growth of 28 per cent in the June quarter alone. The increasing contribution from the sector pleased asset owners and managers around the world who are being forced to offer members and clients greater transparency into the impact their investments are having on the environment. With data comes power.

Ultimately, the result was strong sales growth of 8.7 per cent despite cancellations coming from the struggling hedge-fund sector. Organic revenue growth remains key for index providers, with greater assets under management ensuring margins remain strong at over 50 per cent. Subscriptions grew 10 per cent in the quarter.

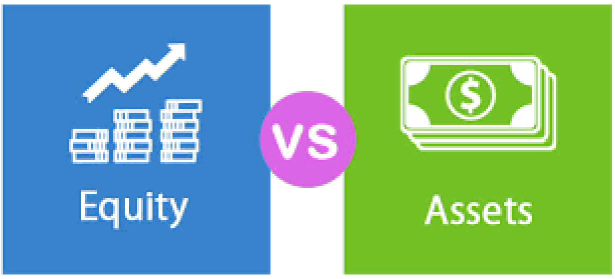
But, with great power comes great responsibility. One of the more interesting results of the passive and semi-passive trend is the incredible power that is being placed in the hands of index operators and data providers. Consider, for instance Tesla Inc. (NASDAQ:TSLA), which fell more than 20 per cent in a single session after Standard and Poor's decided against its addition to the S&P 500.

Some would suggest MSCI holds even greater power due to the growing importance of the developing markets and its important role in their growth. For instance, MSCI's recent decision to relax the restrictions on China A-Shares for its emerging markets index forced passive investors to do the same, sending the market higher.

This once again explains the core value of the MSCI business. The trend to low-cost, passive investing, boosted in Australia, for instance by regulatory moves such as the introduction of MySuper for big funds, is forcing a game of 'follow the leader' as managers can't afford to underperform their benchmarks for very long at the risk of losing their jobs. While many have suggested the approach is 'counterintuitive' the smart ones have been backing MSCI anyway.

Seeking income from credit

- Investment Committee -



As highlighted earlier in this report as well as in recent issues, the team at Wattle Partners are increasingly seeking alternatives to the traditional bond and equity markets as we seek to deliver returns for our clients. In our view, the conditions have never been more difficult, particularly when it comes to generating an income.

2020 will be remembered as the year that interest rates around the world finally hit zero, and actually negative when adjusted for inflation. It will also be remembered as the year that the seemingly never ending flow of fully franked dividend was interrupted, potentially for good.

In this environment, we believe investors should be seeking more secure sources of income, preferably via debt and bond positions, rather than equities. Interest payments on bonds are of course legislated and must be paid, whilst dividends are discretionary, just like executive bonuses.

One such opportunity we are highlighting this month is the Invesco Senior Secured Loan Fund. As you will see, the fund invests into the debt of so-called 'junk bonds', however, this definition should be taken with a grain of salt as we highlighted in a previous article. Some 50% of all corporate bonds on issue in 2020 are now considered 'below investment grade' or unrated. This doesn't necessarily mean they are all bad or poor quality companies, some simply don't wish to pay the rating agencies for the please of a ratings review, or do not require the lower interest rates associated with higher credit ratings.

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Who is Invesco? Invesco is a global asset management business founded in 1935 with operations spanning 120 countries but headquartered in Atlanta, Georgia. The group has over $1.7 trillion in assets under management across fixed income, equities, multi asset and credit strategies.

Invesco Credit Partners is the corporate lending division of the firm, established in 1982 and employing over 115 staff. The team currently manage around $31bn across the entire spectrum of corporate lending including investment grade, distressed, senior secured, unsecured, with a smaller and medium sized company focus. Invesco's Credit Team has outperformed their benchmark in 98% of rolling three-year periods since their inception.

What does the fund invest in?

This fund will invest into a portfolio of floating rate, senior bonds secured against the assets of sub investment grade companies (being below BBB-credit rated or unrated). The Invesco Credit Team, which includes the Credit Partners, Bank Loan and Direct Lending teams offers an unrivalled loan sourcing opportunity for investors, as well as a strong platform of due diligence.

Nearly every bond issue open to this new fund has already been through a full due diligence with another part of the Invesco team, reflecting the huge synergies the company can leverage.

Where does it fit in portfolios?

The higher yielding nature of this strategy means it invests into US issued bonds with lower credit ratings that aren't sufficient to meet the criteria to fit into the traditional fixed income allocation. The fund has therefore been included in the Defensive Alternatives allocation for two reasons; firstly, due to the lower volatility compared to equity markets it experiences, less than 50%; and secondly, due to the history of much lower top to bottom falls in the value of its assets.

What does it own?

The fund offers a unique exposure to a sector of the global fixed income markets that is normally off limits for retail investors. Senior Secured Loans are secured by the physical assets of the underlying businesses, with loan or bondholders the first in line should the company enter bankruptcy or administration. These sectors have been shown to offer non-correlated returns compared to more volatile equity markets, particularly when active management and experience is applied.

The fund is 100% currency hedged, fully liquid, offering daily pricing and withdrawals with distributions paid monthly.

How has it performed?

The events of March 2020 during which bond markets were disrupted by forced sellers and limited liquidity, saw the strategy fall over 15% for the quarter. However, it quickly rebounded 14% in the six months that followed and is now down just 2% for the 12 month period.

The fund currently holds a diverse portfolio of loans spread across electrical (11%), telecommunications (9%), business services (7%) and utilities (5%) among many others. 93% of the underlying loans are secured with just 2% unsecured and 82% issued by US companies. With the largest holding under 2% of the fund, it is well diversified including over 50 individual holdings.

We have traditionally avoided this part of the bond or credit sector, until now, for the reasons shown during the March sell off. But with economic conditions improving and unwavering central bank support, the fund offers a unique income diversifier.

Why invest?

The sub investment grade or 'junk' bond sector is often mischaracterized as being high-risk or poorly managed. Yet the reality is that many small and medium sized businesses simply do not have the resources or interest to seek credit ratings from the major agencies which come at substantial costs. One example is the largest holding in the portfolio New Red Finance, which is bonds issued to support the owner of Burger King in the US, and secured by their assets.

This offers opportunities for fundamental investors like Invesco, who are able to make their own credit assessments of businesses and review more detailed company information obtained from decades of experience in the sector.

In many cases, they are able to purchase otherwise strong businesses at substantially higher yields or lower valuations than would otherwise be the case. After massive growth in borrowing as interest rates near zero, the global bond market now exceeds the value of global sharemarkets by close to three times, at over $100tn.

The senior secured market that Invesco targets is closer to $1.3tn, meaning the opportunities are nearly endless.

What income does it provide?

The fund has provided a consistent income of around 5% per annum over the last five years, with the running yield for investors today, around the same level.

Wattle Watch – Potentum Partners

POTENTUM
PARTNERS

We were lucky enough to catch up with the team at Potentum Partners during the month. Potentum is a specialist private equity manager run by Steve Byrom, Jasmina Osmanovic and Dave Simons. If the names are familiar, it is because the team are among the most well regarded and successful private equity managers in Australia. The group worked together for many years at the Future Fund, building and managing the Funds private equity platform from scratch to the c$20 billion it manages today.

Fortunately for us, the structure of the public service doesn't always fit well with private equity, so the team have gone out on their own to offer a brand new fund to high net worth and advised investors. As you would expect from private equity, it is a very long-term strategy, leveraging on their extensive relationships with some of the world's leading and emerging private equity managers. It will offer investors both access to a core portfolio of external private equity funds, as well as to co-investments into individual assets and companies on a regular basis.

The team is wary of the inherently difficult nature of offering private equity investments with transparency and balancing the objectives of both the investee companies and unit holders, with some unique opportunities to ensure no one is left out.

In a world of low interest rates and heightened equity market valuations, seeking alternatives to assist in meeting long-term growth objectives has never been more important. Please let us know if you would like to learn more about the fund and the team at Potentum.

COVID-19 – A time for new vision

- The Silver Mongoose -

As Einstein observed *"in the middle of adversity there is great opportunity"* and this was never truer than it is in the Covid world in which we now live. The choice is do we, as a nation, take advantage of the opportunity; or do we merely seek refuge and long for a return to a pre-Covid19 world because that is what we know, and it was comfortable.

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This is an important choice we face as a nation as it will shape the future Australia for the balance of the 21st century. Covid19 actually needs to be viewed as a significant opportunity for business innovation and restructuring across the entire economy. It should not become a plaything for politicians for cheap political point scoring and their short termism thinking.

What sets us apart is the ability to adapt and change and live with uncertainty. What is critical is that the survivors are those who do so speedily and can move on creating wealth and economic growth.

Australia, because it is an island economy, or less elegantly put we live on an island in the middle of a sewerage farm, has the opportunity to make a leap out of being an economy where the "*rich listings*" consistently are dominated by property developers and mining operators. Our technology, biotech, and other industries where high level intellectual capital is required to create wealth, barely rate a mention. The undervaluing of intellectual capital is a major cultural failure in our society when compared with other advanced economies. Further we consistently over value skill sets associated with accounting and law and undervalue those driven by STEM.

The UK and Europe have a tradition of promoting excellence in scientific innovation and research in topflight universities so there is much we can learn from that investment particularly in post graduate education and theoretical research and not just applied research to solve industry's problems of the day is key to our future.

Australia has hardly been the crucible for innovation in the region. Island economies can engender lazy thinking because they are protected until an invader takes over. Covid19 needs to be seen in that light. It needs to be the catalyst for change and innovation. Covid19 offers us the opportunity to make significant structural shifts in our economy to be something other than a farm, a hole in the ground, a housing estate, or an international destination for education or a holiday.

The change may need to be brutal. Yes, we may see a raft of restaurants and cafes serving overpriced average quality food disappear; yes, barista's wages may take a hit; yes bars and gin palaces may not reopen; clothing stores may shutter for good; all characterised as operating within a "monopolistic competition" framework. Their demise was brought forward on a faster timeline with Covid than would have occurred as the economy gradually slid into recession in later part of 2019.

Past structural changes in Australia often have been gradual ones as we transitioned from an agricultural economy to manufacturing to services and mining. But there have, at times, been seismic shifts, and when they have occurred, this has required rethinking decades long policy levers (e.g. floating currencies, removing tariff barriers to become an outward facing economy, or removing barriers to population flows). It has required repositioning our economic alliances from a slow-moving economy of Europe to fast growing east Asian economies.

Now is one of those times when everything should be questioned and rethought; but are our political leaders up to the challenge to lead Australia and foster the next significant structural change to reshape the economy. One would hope so, but the 2020 Commonwealth budget does not fill one with hope that the impetus for change is going to come from Treasury. Someone, or some other economic agency, is going to have to fill the void evidenced by the Treasurer's recent performance. Do any of the policy flagships in the budget make sense in delivering jobs and growth but more importantly repositioning and transitioning the economy to a knowledge driven innovative economy with quality intellectual capital.

If the 2019 budget was a homage to ACDC "Back in Black" then 2020 looks more like John Lennon's "Watching the Wheels", appropriately was released after his death. The Treasurer's "walk" ahead of the budget was redolent of Banquo's ghost, lost and adrift.

So, none of this goes anywhere towards a radical restructuring the economy to a Post Covid new world. One suspects that the Treasurer realises this, but he has been pushed by political forces to spend on the past not the future, because it seems electorally popular for the 2021 federal election.

Recently there have been some glimmers that the Government was finally positioning the debate and framing Australia's future. We started to enunciate an energy policy with some elements of innovation

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in it. We finally were starting to address education, training, and further education even if thinking on innovation and research has become muddled. But more on that another day.

The Government has had the roadmap for change in its hands since the 2017 *Shifting the Dial* report from the Productivity Commission. It is a pity that this was not used as the primer in framing the budget for 2020.

Right today it appears that Australia is not going to use the adversity of Covid19 to create the great opportunity to radically reshape the Australian economy for the coming decades. We can only hope that innovation, economic restructuring, and growth that Australia requires quickly becomes the focus for the businesses policy agenda in Australia in 2021.

The Silver Mongoose is a friend of Wattle Partners. The views of the Mongoose are all it's own.

Market Thinkers Podcast

If you haven't had the chance to attend one of our live sessions, our interviews with leading managers are now available to download via Apple and Spotify Podcasts along with You Tube.

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