UNCONVENTIONAL WISDOM

Unique investor insights from Wattle Partners

August 2020

The month that was...

- The Australian economy contracted 7% in the June quarter, officially confirming what has been known since April; we have entered a technical recession. The trust placed in 'expert' economists continues to confound the team at Wattle with most predicting a 5.5 to 6.5% contraction just a few days before. If there ever was an opportunity to add an 'asterisk' to an economic announcement it is this one, with Government's effectively pulling the pin on the economy to protect the health of the population. The highlight was a 1% boost from our trade surplus as imports were slowed due to travel restrictions, but clearly insufficient to offset the 12% fall in household consumption and 18% in services. Government spending offered little support, adding 0.6% for the June quarter. The result taking the annual economic growth figure down 6.3%.

- Once again Australia has been protected by its relationship with China, with comparative quarterly growth contractions around the world much weaker including 9% in the US, 20% in the UK, 12% in Europe and down 13% in Spain. Media headlines will point to the huge increase in the savings rate to 20% from 6%, yet anyone locked down in Melbourne will attest to the inability to spend money on anything but Kogan Ltd (ASX:KGN) or Woolworths Ltd (ASX:WOW). Unfortunately there is likely to be more bad news to come, but this will fall in 2021 and beyond, when the likes of JobKeeper and JobSeeker payments are removed, unemployment inevitably increases and the real brunt is felt in the property sector.

- Once again, the Federal Reserve appears to be leading global central banks, abandoning its inflation target and focusing on delivering full employment. Despite protestations there are many similarities behind the evolving set of policies and the concept of Modern Monetary Theory; being a focus on full employment and a realisations that Government deficits reflect capital being added to the economy at a time of need. Not to mention most central banks are now effectively financing deficits but via bond purchases from financial institutions rather than from the Treasury directly.

- With a backdrop of the weakest economy since the great depression, both the US and Australian sharemarkets delivered reasonably resilient earnings seasons. The S&P 500 for instance delivered actual earnings 23% higher than expected, making it the largest positive surprise in history. On the one hand, it is clear that stimulus policies are supporting spending, but primarily in e-commerce and technology related

businesses from Amazon to Apple. In Australia, aggregate earnings were down 38% from 2019, however, a large portion of this reduction was driven by non-cash impairments like the reduced valuation of oil and gas facilities or the loan books of the major banks. The biggest disappointment by far was the wide range of dividend cuts and outright cancellations, with estimates suggesting total dividends fell by 36% for the period to $62 billion. We cover each of our Model Portfolio holdings results in the following section. Despite diverging performance, the S&P500 and ASX 200 have one thing in common – concentration – with 23% of the former made up of the major tech names and our own market concentrated in BHP, Westpac, CBA and CSL. Despite valuations its clear which market has greater earnings growth potential.

- The war of words between retailers and landlords has only just begun. Westfield mall owner Scentre Group Ltd (ASX:SCG) took the extraordinary step of locking out Noni B owner Mosaic Brands from 150 of its stores as their 'negotiations' on rental agreements ramped up. It is clear that the days of fixed rent increases for struggling retailers are gone, yet as they say, whoever holds the keys holds the power. This will take some time to play out.

- On the other hand, Australia's reliance on immigration and overseas travel has been exposed by the extended border closures, but it may have more profound impacts on our property sector in the years ahead. The consistently positive outlook for real estate in recent years that has driven the massive amount of residential development was driven by an expectation that immigration would continue unabated between 1-2% of the population each year. Put simply, such a huge reduction in demand, both renters and buyers, is likely to put huge pressure on valuations as more supply comes to market. The likes of developers Harry Triguboff and Tim Gurner are acutely aware of the issue. Our ongoing relationship with China will have a key role to play.

- Culture and governance issues raised their heads once again during reporting season, with investors increasingly calling out boards in the public arena. AMP Ltd finally made the right decision, refreshing their board by removing the 'old bankers' and cleaning out their executive leadership roles. QBE saw its CEO sacked after breaching their internal 'code of conduct' policies, with many institutional shareholders very vocal. On the other hand, there appears to have been little change at Rio Tinto Ltd (ASX:RIO) despite blowing up a 50,000 year old archaeological site.

- It went from a week of disaster to one of hope according to out politicians, announcing we had 'secured' our share of a yet to be approved or fully tested vaccine. Positive news on the one hand, but potentially a little too hopeful. In the event that a vaccine is approved sooner than expected, investment portfolios may well be underprepared for the incredible rally that ensues with the more cyclical companies likely to catch up to the rest.

Model Portfolio Update

- Investment Committee -

Index	Index Points - July	Index Points - August	Performance 1 Month	Performance 1 Year
S&P/ASX 200	5927.78	6060.46	2.24%	-8.23%
All Ordinaries	6058.31	6245.88	3.10%	-6.75%
US Dow Jones	26428.32	28430.05	7.57%	7.68%
US S&P 500	3271.12	3500.31	7.01%	19.61%
Hang Seng (HK)	24595.35	25177.05	2.37%	-2.13%
FTSE 100 (UK)	5897.76	5963.57	1.12%	-17.26%
Nikkei 225	21710.00	23139.76	6.59%	11.76%

Top 5 Performers	1 Month	Bottom 5 Performers	1 Month
Boral Ltd	11.70%	Telstra Corporation Ltd	-13.73%
CSL Ltd	5.89%	Seek Ltd	-4.61%
Munro Global Growth Fund	5.15%	Commonwealth Bank of Australia Ltd	-4.10%
Franklin Global Growth Fund	5.10%	Gold Bullion ETF	-2.37%
GQG Partners Global Equity Fund	4.91%	Magellan Infrastructure Fund	-0.60%

The Wattle Partners Model Portfolio continued its strong recent performances, adding over 1% for the month of August and 5% for the 12 months. Once again, it was the global equity exposure delivered through professional fund managers, Munro, Franklin and GQG that powered returns higher. These funds offer a core exposure to the fastest growing companies in the world and offer important diversification away from the less diverse Australian economy. For some insight, the core holdings of each fund are as follows:

- **Munro:** Amazon, Facebook, Alibaba
- **GQG:** Microsoft, Astra Zeneca, Tencent
- **Franklin:** Shopify, Mercado Libre, Visa

Divergence

The story of the month has been divergence. On the one hand Australia vs. the US, with the US adding 7% for the month and 20% for the 12 months, but Australia up just 2% and still down 8% for 12 months. But also divergence within the eleven key sectors of the economy. Whilst the sky high valuations of US markets for good headlines they hide the fact that over half of the other listed companies are still between 30% and 50% lower than their pre-COVID highs. These are ultimately in more cyclical sectors, with the rotation out of energy, property and banking sectors going directly into consumer and technology driven companies. If you missed out on the latter performance will be far lower.

Sector	August	12 Months
A-REIT	7.69%	-20.83%
Communications	-5.16%	-11.15%
Cons. Discretionary	7.78%	6.18%
Cons. Staples	-0.77%	3.02%
Energy	2.67%	-30.69%
Financials	0.40%	-23.61%
Healthcare	3.93%	14.44%
Industrials	4.34%	-15.32%
IT	15.26%	35.66%
Materials	0.26%	8.05%
Utilities	-5.86%	-10.60%

Reporting season updates

CBA profit dips 11.3% but dividend at the limit

The Commonwealth Bank of Australia Ltd (ASX:CBA) handed down their financial year result today; beating guidance on its dividend, but not on earnings. Management reported a 12.4% increase in statutory profit, which includes gains on the sale of assets including CFS, to $9.6 billion, but real cash profit fell 11.3% to $7.3 billion. The biggest hit came from higher loan impairments, effectively reducing the value of their loan book to account for potential losses, which increased $1.2 billion in the year; still tiny compared to the $200+ billion loan book. CBA declared a 98 cent per share dividend for the second half, a 60% cut on the 2019 dividend. The dividend is at the upper end of APRA's 50% of profit guidance, hitting 49.95%. Based on the current share price of around $75, the dividend yield is around 4% before franking, far lower than the 6.5% most investors are accustomed too, in my view, this is where the dividend will sit for several years now requiring an adjustment from income seeking investors. On the positive side, CBA saw $15 billion in new deposits, potentially coming from people

taking advantage of the early superannuation withdrawals and putting the funds in their offset account. CBA's loan book is now 74% funded by cash deposits and supported by their 25% market share for all home loans.

SEK hit hard by COVID-19, cuts dividend to focus on investment

Employment and online education group, Seek Ltd (ASX:SEK), delivered a weak result but not unexpectedly; job advertising in a pandemic isn't easy. Despite an incredibly difficult second half of the financial year, the company reported a 3% increase in revenue to $1.57 billion. Management continued to target $5 billion in revenue, but this has been pushed out beyond the original FY25 target. Regardless, this sort of foresight and initiative is what has driven SEK's growth for many years. The Australian business was hardest hit, falling 12% with billings bottoming at 65% of 2019 levels, whereas the Chinese Zhaopin business remains the leader adding 12%. The board is now forecasting a reasonable 2021, but with earnings to remain below 2020 peak levels. The company managed to stay cash flow positive even throughout April and May, finishing with a net profit of $90.3 million, down 51% on the prior year. This was reduced to a statutory loss of $111.7 million due to the downward revaluation of SEK's investments in Latin America and Asia. Importantly, cash flow remains solid, albeit below 2019 levels, with $409 million being received. The CEO has, however, decided to cancel the dividend, in an effort to avoid a discounted capital raise and focus on their continued investment and development opportunities. The highlight in 2020 has been the growing Online Education Services, which includes an investment in Coursera. The business unit grew 7% in 2020 and is likely to benefit from the COVID-19 tailwind of re-skilling and the need for online education courses for new employees.

ANZ cuts dividend by 70%, despite a strong finish to the year

ANZ delivered a strong result, cash profit hitting $1.33 billion in the third quarter, as their Institutional Markets division enjoyed a tailwind of activity. This beat the entire first half profit of $1.54 billion as impairments and loan write-downs began to slow. Management saw sufficient strength to declare a 25-cent dividend, a cut of 70% on 2019, but a surprise given Westpac's (ASX:WBC) decision to cut their own dividend on Tuesday. The bank took another $500 million in provisions in the June quarter, some specific to individual loans and others a collective adjustment to their risk weighted assets due to COVID-19. The markets division, which offers various trading and hedging services for institutional clients, grew 60% in the third quarter, whilst ANZ grew their home loan book well above the rest of the market, with some $10 billion in new loans during the quarter. The biggest concern is the continued reduction in their net interest margin, to 1.59%, the lowest among the majors, likely due to their struggling Asian businesses. One of the more interesting insights came from their deferred mortgage book, where deferred mortgages are clearly higher risk, with an average LVR or 68% compared to 56% for the rest of their accounts and balances also substantially higher, $371,000 compared to $272,000.

CSL, the gift that keeps on giving

CSL Ltd (ASX:CSL) solidified its position of one of Australia's true global leaders, delivering profit growth of 17% in constant currency terms for the financial year. The share price had weakened in recent months amid concerns about plasma collection and COVID-19 related costs, both seemingly unfounded. All businesses units except the restructure Albumin drug, delivered double digit revenue growth for the financial year; the most important Privigen and Hizentra lines up 20% and 34% each. The result was a 9% increase in revenue, 10% increase in reported profits to $2.1 billion and a similar increase in the full year dividend. CSL relies on its growing network of blood collection centres in the US, to which it added 40 in 2020, to develop its treatments, with management importantly confirming that all centres remain open and collections falling just 5% on 2019. They actually announced the intention to open 20-30 new centres in the next 12 months and further solidify their near monopoly. The only concern was the slowdown in sales across Asia Pacific, -29%, which was previously flagged and represents a reset of distribution strategy, rather than an outright fall. The standout in my view was confirmation that the company would spend another $1.6 billion on innovation in FY21 which for comparison is equivalent to the value of the entire market cap or

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IOOF Holdings Ltd (ASX:IFL). CSL was one of the few offering an outlook statement, expecting revenue growth of 6-10% and a slight improvement in profit of up to $2.26 billion.

Wesfarmer's Ltd (ASX:WES) - Officeworks and Bunnings booming but is a spending cliff ahead?

Wesfarmer's Ltd delivered its financial year result this morning, flatting a 10.5% increase in revenue from continuing operations (i.e. excluding Coles) and an 8.2% increase in net profit to $2.08bn, a slight beat to expectations of $2.0bn. The highlight was a strong dividend of 0.77 cents per share, down just 1 cent from 2019, along with an 18 cent per share special payment from the sale of 10% in Coles Group Ltd (ASX:COL). By and large WES remains a shell for the dominant Bunning's franchise, which saw revenue increase another 13.9% to $15bn and some 50% of the entire group. Second half sales were particularly strong up 245 in the second half, however, management have flagged the potential for a spending cliff as stimulus payments reduce towards the end of 2020. As expected, Officeworks delivered 20.4% sales growth and a 14% increase in earnings to $197 million as the population looked to set up home offices, upgrading everything from computers to office chairs. The now combined Target and Kmart division hides the weak performance of the former, sales down 2.6%, with Kmart continue to deliver higher sales, 5.4%, but a fall in earnings due to store closures. Management flagged a switch to a JB Hi-Fi Ltd (ASX;JBH) approach as they seek to integrate the acquisition of Catch Group, by using the diverse Kmart and Target network as a Click and Collect site for online purchases; a sound strategy to maximise their huge floor space. The real reason investors hold WES is their ability to deploy capital and run strong businesses, this was proven once again by the leading return on capital levels achieved at Bunnings (50%), Kmart (30%), Officeworks (17%) and even their WesCEF division (33%), which means they are putting shareholder capital to work for profit. With essentially no debt and free cash flow exceeding $4 billion there is little doubt WES will be seeking another acquisition as the fallout from COVID-19 continues. **Summary:** Great result but some uncertainty ahead in 2021.

BHP underwhelms, announces exit from coal

It rare that a $9.06 billion profit underwhelms, but consensus targets for BHP Group Ltd (ASX:BHP) underlying profit were 4% higher at $9.42 billion. The result was 1% lower than 2019 with some cost increases and COVID-19 related slowdowns impacting the business. It was also impacted by the devaluation of their Cerro Colorado mine and the cancellation of power contracts in Chile to be replaced with renewable energy generation. The dividend was cut by 10% to $1.20 per share, but capital returns remain a key focus as the company's cash flow generation remains strong, free cash flow was $8.1 billion. The strength of BHP is reiterated every time it reports, with profit margins of 53% and some of the lowest cost commodity divisions in the world. For instance, BHPs cost of iron ore production is just $12.63 per tonne, compared to current prices exceeding $100; the unit commands 64% of the business's earnings. Interestingly, a $1 move in the iron ore price represents $233 million in earnings for BHP. The copper division, which represents 19%, remains strong as global demand for electric vehicles and batteries ensures demand will remain strong for the foreseeable future, BHPs cost of $1.01 compares favourably to current $2.80 prices. Management flagged the decision to exit the production of coal through a potential sale of demerger and highlighted huge efficiencies coming from the rollout of machine learning and automated work sites around the world. Who said mining companies couldn't be technology leaders? **Summary:** Another solid result, coal exit a positive, dividend remains secure.

National Bank shows foresight, deferrals slowing

National Australia Bank Ltd's (ASX:NAB) decision to cut its dividend and raise capital is looking prescient after its third quarter trading update. The bank reported a 10% increase in revenue during the quarter, benefiting from higher markets income, but importantly its capital position at improved to 11.6% in line with the Commonwealth Bank of Australia Ltd (ASX:CBA). Cash earnings fell 7% to $1.55 billion, a positive result in the circumstances, and the board decided further COVID-19 loan impairments weren't required at the current time. In a sign that perhaps it isn't as bad for NAB as the other majors, they announced that 16% of deferred loans had seen repayments commenced, with 8% of loans no longer

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frozen. One of the interesting insights from the bank reporting has been the spread of repayment deferrals, with Victoria representing just 28%, despite the remained of the country being in far less stringent lockdown conditions. This follows reporting yesterday that unemployment rates in Queensland and Western Australia are actually worse than in NSW and Victoria. **Summary:** Great result in the circumstances, supporting a second half dividend.

Qube takes a revenue hit, but shows resiliency

Qube Holdings Ltd (ASX:QUB) reported a 9% improvement in underlying revenue, increasing to $1.8 billion driven by a strong first half to the financial year. Yet with the onset of the bushfires and COVID-19 in February, profits fell 15.4% to $104 million on an underlying basis. This compares to a 32.2% contraction in statutory profit to $214.7 million due to the positive revaluation of its various property assets in the previous financial year. Weakness was felt across the business as global trade was forced to slow, but particularly in container volumes and automotive shipments. The 50% owned Patrick division saw a 9.4% fall in net profit to $34.5 million whilst the Infrastructure Division, including the Moorebank Terminal fell 48.5% to $20.2 million; with both expected to be short-lived weakness once the pandemic subsides. Despite the major disruptions and higher costs, management were able to deliver earnings growth over the prior period in a number of markets and win two major contracts, with Shell and BlueScope Steel, which will be their largest ever by revenue once complete. Managing Director Maurice James stressed the resiliency of the businesses diversified and vertically integrated business model, and its ability to deliver a sound performance "in light of the very considerable, unexpected and unprecedented challenges". The dividend was cut from 2.9 cents to 2.3 cents per share which was in line with expectations. **Comment:** Tough conditions, but market dominance supports the dividend.

AMP stems the bleeding, pays a special dividend

After some self-inflicted pain AMP Ltd (ASX:AMP) appears to be turning the corner. CEO Francesco De Ferrari looks to have surprised the market announcing the companies first dividend since 2018, a special payment of 10 cents per share. The dividend was accompanied by an on-market share buyback of $200 million, which should support the share price. The long-awaited exit from life insurance has placed the company in an enviable position, with some $1.4 billion surplus capital even after accounting for these capital initiatives. Looking closely, underlying profit fell 42% to $149 million from $256 million, a solid result despite the headlines that have followed. Every business line contributed to the result, with wealth management delivering $59 million, despite cutting the costs of its AMP North platform and losing $1.3 billion in super accounts; assets under management finished at $121 billion. AMP Bank remains a growth driver, increasing customer deposits by 18% and delivering $50 million in profit, whilst AMP Capital remains the core profit centre, $72 million, even as performance-related fees on infrastructure and property assets fell 40% for the financial year. Management clearly sees the value in this business, repurchasing the 15% it doesn't own from Mitsubishi UFJ Trust, a Japanese institutional investor. **Summary:** A solid result with clear signs the company has bottomed.

Telstra maintains dividend, everything in the world is right again

Telstra Corporation Ltd (ASX:TLS) reported in line with previous guidance, total income falling 5.9% to $26.2 billion and net profit down 14.4% to $1.8 billion. The companies results remain as messy as ever as the transition away from the NBN continues, however, the most important announcement was that the dividend was maintained at 8 cents per share. Despite seeing earnings contract due to NBN installations, TLS still garners 46% market share of new connections and has used the payments for its copper wires to bring forward its leading 5G network. Some 10 million people are now covered by ultra-fast 5G and CEO Andy Penn brought forward his intention to increase this to 75% of the population by June 2021. Management have clearly identified the 'acceleration in the digital economy' and how critical TLS is to the eventual economy recovery, particularly as working conditions change. The mobile businesses added 240k new customers for the year and 'internet of things' products grew even faster, with 652k new additions. Whilst primary viewed as an income play, TLS is showing signs of growth, growing earnings by $40m when the NBN

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losses are stripped out, this even after an estimated $200 million in COVID-19 related costs. The company also announced it has been 100% carbon neutral in 2020. **My take:** Good signs for this digital infrastructure business.

More patience required for Boral Ltd (ASX:BLD)

New Boral CEO Zlatko Todorcevski handed down the financial year results of his predecessor and it wasn't pretty, but it was a beat on expectations. The business managed to surpass expectations, which were lowered following a pre-announced $1.3 billion impairment, net profit excluding this was $181 million, substantially better than the $166 million expected. However, the new board elected not to pay a dividend for the second half, following a 30% fall in earnings to $710 million. Whilst a slight disappointment, its important for management to have as much capital available as possible to ramp up production into what is likely to be a global infrastructure boom. The annual report once again highlighted their diversification, exposed to both US and Australian residential construction, but importantly 25% of sales is still coming from Roads, Highways and Bridges in Australia, with an extensive line up of projects from the Cross River Rail in Queensland, to the Westgate Tunnel in Victoria. Management highlighted a 19% decline in Australian housing starts and further 20% weakening in construction in Victoria to start the financial year, yet financial year revenue only reduced by 5%. It was a similar story in the US, with revenue down 2% as 80% of concrete production plants were impacted by COVID-19 shutdowns. The operating team made important adjustments, cutting production and running down inventory to avoid any cash flow issues, with $631 million in cash produced during the year. On the outlook, the CEO was quoted as saying "with insufficient market visibility, Boral is unable to provide guidance for FY2021". But importantly, he also stated that Boral "have started FY2021 with lower revenues but only slightly lower earnings relative to the same time last year" meaning cost cutting measures have been successful. **Comment:** Diligent management avoided a capital raising, positioning for an infrastructure boom.

How an ETF really works?

- Vanessa Cullen -

Exchange Traded Funds or ETF's are an increasingly popular investment choice due to their low cost and market benchmark exposure. We take a closer look at the inner workings of these unique options below.

What is an ETF?

ETF's are open ended investment funds, similar to traditional managed funds, with the key difference being they are trading on a stock exchange like the ASX. Open ended means that new units are issued when requested by new investors. The legal structure is typically a unit trust, with each unit in the trust providing the holder with an interest in the underlying assets. Most ETF's differ from traditional managed funds as they aim to simply track the performance of an index, rather than seek to outperform or make active investment decisions.

This means the unit trust will enter the market and buy an index weighted number of shares in each company into which you will have a direct interest; as the index changes, your holdings will also change. The fact that there is no external input is the reason they are generally referred to as 'passive' investment options.

The major differentiating point between an ETF and a typical managed fund is that the units can be traded on a daily basis on the ASX at a market-determined price and that they come at a substantially lower cost as the index changes are automated rather than

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requiring human input. This difference introduces the risk that the units may trade at a value that is different to the 'true value' or 'net asset value (NAV)' of the portfolio of underlying shares; which is where Market Maker's come in.

The underlying holdings of each ETF are administered by a custodian and your units are registered with a registry provider like Computershare or Link Market Services, in the same way as any direct share may be.

What is a Market Maker?

The role of a market maker is to satisfy supply and demand for units in each ETF. The market is typically a large investment bank or institutional investor who regularly have positions on both sides of the market (buying and selling). The market maker provides liquidity to the market by acting as the buyer and seller of units during each day, and by creating and redeeming units off-market. This ensures that the number of units on issue matches supply and demand, which assists in ensuring the ETF does not trade at a material difference from its NAV. P

ut simply, the market maker removes any arbitrage by buying or selling ETF units, converting them into the underlying shares and cancelling the units and vice versa. Importantly, the NAV is published daily for each ETF to ensure a transparent market and you will generally see small units on both the buy and sell side of the market as the market maker ensures the NAV is matched. In the worst case, advisers are able to contact the market maker to determine the NAV at any time.

Why use ETF's?

ETF's offer many benefits to investors, particularly those with smaller balances seeking more diversification within their portfolio, or those just getting started in investing. The five main benefits are as follows:

- **Cost Effective –** Because ETF's simply track the performance of an index by replicating its holdings, there are limited investment staff required and no 'active management fee' required. ETF management fees can be as low as 8 basis points or 0.08% for the most widely traded indices.
- **No Minimum Investment –** ETF's do not require a minimum investment, apart from normal ASX minimum trade size rules, meaning you can invest with any amount of capital. You do not need to meet the $10,000, $25,000 or $100,000 minimum applied by some fund managers.
- **Diversification –** The nature of ETF's is that you have an exposure to every company in an index, which may be as few as 50 companies and as many as 500 for the US S&P 500, providing substantial diversification. ETF's allow investors of all sizes to invest into asset classes, like global shares and Government Bonds, that are typically limited to institutions.
- **Transparency –** Fund managers are typically only disclose their largest investment holdings as this information is key to their performance, ETF's on the other hand provide complete transparency into every underlying investment even down to the number of shares in each company.
- **Liquidity –** For the largest ETF's liquidity will never be an issue and investors have the ability to sell their units on market at any time of their choosing. In comparison, managed fund must be redeemed at the end of a trading day and require the manager to have sufficient cash to fund the redemption.

What are the risks of ETF's?

ETF's are not without risk, the primary ones being the risk associated with the underlying investments that make up each strategy. More generally, the following are worth considering:

- **NAV Premiums and Discounts –** Where there is not sufficient liquidity or volume, ETFs may trade at levels above or below

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their NAV, meaning investors may not have a true reflection of the value of their investment;

- **Volatility –** ETF's are by their definition fully invested at all times, they do not hold any cash, and will move in line with their underlying index both up and down. They will therefore be more volatile than a similar active fund in certain circumstances.

What are the costs of ETF's?

The costs of ETF's are limited to the brokerage paid to the share trading service and your financial adviser. As the implementation process for ETF's requires regular contact with market makers to ensure the NAV is met, advisers may charge additional brokerage to facilitate these trades.

The only ratio you need to know for picking stocks

- Amanda Bouzeid -

If it wasn't clear in 2019, it must be clear now; value investing is dead.

Looking solely at the performance of the growth heavy Nasdaq versus the S&P 500, the difference is stark. Nimble, fast growing, technology-enabled companies with growing addressable markets are the clear leaders and winners post COVID-19. The Nasdaq is up 22% in 2020 and the S&P 500 just 2%.

In a world where value is dead and growth stocks have sent market price-earnings multiples to multi-decade highs, there must be a better way to assess and identify opportunities. Return on invested capital may be the solution.

Return on invested capital is a straightforward ratio commonly used to assess how efficiently a company is at allocating the capital that you provide as a shareholder into profitable investments.

Put even more simply, how well is the management of say Boral Ltd (ASX:BLD) using its shareholder capital to generate returns (not pay dividends).

In my view, it is one of the most pure and useful financial ratios going around. If you compare the return on invested capital or ROIC of a business, with its weighted average cost of capital or WACC, you can quickly tell whether that company is generating positive returns from your investment, or simply wasting money.

We will cover the WACC at a later date, but as a short introduction, it represents the cost of both the debt and equity of a business, the former determined by interest rates and the latter by how difficult it is to raise capital.

The ratio for ROIC is simple, but the devil is in the detail:

$$\frac{\text{Net Operating Profit After Tax}}{\text{Invested Capital}}$$

Or going one step further:

$$\frac{\text{Net Operating Profit After Tax}}{\text{Debt + Equity but excluding non-interest bearing liabilities like tax payable}}$$

Net operating profit requires you to add back the cost of debt before applying this figure to ensure a comparable result.

Many analysts and managers preferred to use the more readily available EBIT figure, being Earnings Before Interest and Tax. However, as usual it is important to adjust for any 'one-off' or 'extraordinary' items that management have sought to exclude from the normal operating profit, if they are in fact due to poor decisions in the past.

Interesting, the ROIC is most useful for companies making significant and regular investments, whether in the form of IT, manufacturing or other capacity.

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It is less relevant for companies that effectively act as pass through entities for dividends.
In simple terms, investors should seek companies who are generating an ROIC that exceeds their WACC by at least 2%. Anything under this, suggests they are destroying rather than adding value.

ROIC can also be used to identify value traps, particularly pertinent at this point in time. For instance, if a company has a low P/E it may traditionally be considered as a buying opportunity. Yet if that same company has a weak ROIC than the P/E is likely lower for good reason.

The travesty of Mayfair Platinum

- Drew Meredith -

Clearly, we should have seen it coming. A launch party full of B-grade celebrities on a pristine beach in a cyclone ravaged region, it had all the hallmarks of a disaster. This week saw the regulator taking action against the Mayfair Platinum Group, including its subsidiaries IPO Wealth, Mayfair 101, and M-Notes among others.

The group and its CEO Mr James Mawhinney were taken to the Federal Court in August as the complex web of investments, loans and some $180 million in investor funds continues to unravel. The Australian Financial Review quoted ASICs solicitors suggesting "there is a possibility that criminal proceedings may be commenced against Mr Mawhinney at some time in the future".

It should have been clear when Mawhinney himself was quoted saying "it's not Christopher Skase you're talking with" at one of his conferences during 2019.

This combined with the all-out media blitz which included costly full-page advertisements in the Financial Review, extensive marketing via the Switzer Group's newsletter and Income Conference platform and various other channels should have been enough to alert investors and regulators alike. Unfortunately, it wasn't, with the regulator, receivers and administrators now involved in salvaging the underlying assets for unitholders.

The purpose of this piece isn't to criticize Mayfair Platinum or the regulator, that has been seemingly done to exhaustion, and will no doubt continue to be. Rather it highlights an important issue facing Australian investors and the financial advice industry in general.

Whilst the Royal Commission highlighted important issues and clear conflicts occurring within the industry, many of which will continue to exist post its full implementation, it has done the opposite in improving access to financial advice.
Despite seeking a better educated and ethically aware profession, the Royal Commission has seen some 16% of advisers leave the industry in 2020, down to 22,334 or around 2016 levels. The combination of reducing adviser numbers and higher compliance costs, including advice, administration and staff, has meant firms are now focusing on retaining only their most profitable clients, in some cases asking long-term clients to leave.

This was clearly not the intention, but an unfortunate side effect. With financial advice increasingly inaccessible investors are turning to Facebook groups, discussion websites and the like for advice, not unlike the Robin Hood trading phenomenon in the US.

One thing that financial advisers aren't necessarily known for is their 'bullshit' filter or in more eloquent terms, 'the advice they don't get paid for'.

One of the most underappreciated benefits enjoyed by those who have a financial adviser is their ability to offer a second opinion on the plethora of investment opportunities that are increasingly being sent directly by various means.

Most advisers will readily admit that some of their best advice has been to assist clients in avoiding high

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risk investments, rather than finding the best performing investments. You only need to navigate a few of the financial advisory websites to see many groups raising concerns about risky investments like Mayfair many years before the market did.

The coverage of investors putting their entire life savings into these investments are devasting, but **clearly not** something any competent financial adviser would ever recommend.

The legislated requirement to 'know your client' and 'best interests' duty to ensure any advice is well considered and appropriate ensures clients of advisers of all kinds have the highest probability of navigating the wild west of investment markets.

Sometimes thinking big requires starting small

- Jamie Nemtsas -

ausbil

If there is one lesson from the COVID-19 pandemic, it is that markets never stop and we must evolve to the conditions we find ourselves in. For Wattle Partners this began several years ago with the realisation that traditional 'value' investing was no longer working and that the focus needed to be on the profitability, rather than the valuation of the many assets we consider for portfolios.

More recently, we made the decision to add an exposure to global 'smaller companies' within portfolios in an effort to diversify away from the old-fashioned nature of many ASX-listed business. Whilst the largest technology companies in the world are gaining the most attention, regularly hitting al-time highs, there are thousands of companies around the world offering unique exposures to new and evolving markets. In this vein, we recently added the Ausbil Global Small Cap Fund to our suite of investment options.

As a precursor, it's worth noting that a 'smaller company' on a global scale can have a market cap as large as $5 billion, equivalent to our own Ansell (ASX:ANN) or JB Hi-Fi Ltd (ASX:JBH).

Who is Ausbil?

Ausbil is specialist Australian and global equities manager with around $12 billion in assets under management. Founded in 1997, the company has grown into an ESG or Environment, Social and Governance investment leader and is now 70% owned by New York Life, a multinational life insurance company.

Why is Ausbil suited for Smaller Companies?

Despite being a relatively new fund, it commenced in 2018, the management team including Tobias Bucks and Simon Wood, have 30 year's collective experience at Baring's UK. Both Portfolio Managers come from unique backgrounds, however with a combination of quantitative based, stock screening and real life tyre-kicking experience with investee companies. It is in the latter category that the team leverages to deliver outperformance, as gaining access to the management of smaller companies, is much easier than say Netflix or Apple. The team have a stated focus on finding high quality, unrecognized growth outside where most research analysts will look and in effect are targeting the next Amazon in their search of 4,300 companies spanning 22 countries.

What is the objective of the fund?

The management team are this focused on identifying unrecognized growth and exploiting inefficiencies in the smaller company's sector of the market. The fund seeks to outperform the MSCI Small Cap index by 3%. The team seeks to narrow down their investment universe by focusing only on the highest quality companies, measured by the return on invested capital, price to free cash flow and

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enterprise value to sales. This ensures they are able to avoid value traps typical to the smaller cap sector.

How is the portfolio built?

The portfolio applies a number of restrictions including a maximum holding of 5% in any single company and capped weightings of + or – 20% to any individual economic sector. The result is a well-diversified portfolio of up to 60 companies spread across industrials (17%), IT (14%), and healthcare (15%), a clear differentiation to the financials and mining heavy ASX. The fund has a maximum cash balance of 10% and is diversified across the US (54%), Europe (20%) and Japan (11%).

The highlights within the portfolio are The Trade Desk, which assists smaller businesses in navigating the online advertising market and is now considered as the next 'Google'. Other holdings include Solar Edge, which finances solar installation, Siltronic and commercial property agency Colliers International.

Performance

Despite a weak performance in the March sell down, the fund has outperformed over every period since 2018, delivering 3.6% in July, compared to the index of -0.2% and 8.5% since its addition in May compared to 4.2%.

Why smaller companies?

The fund was added to further diversify global equity exposures into the faster growing, but more attractively priced smaller companies' space. The global smaller companies sector offers an incredibly diverse array of businesses and whilst the weighting to IT is similar to the large cap benchmarks at 14, it includes very different businesses operating in other parts of the economy.

The unique nature of many smaller companies and more focused business models means they tend to offer greater compounding returns, particular when the new Amazon or Google is identified in its early stages. Most importantly, with limited research undertaken by the major research houses, hard work and analysis still offers a competitive advantage in the sector.

One of the key differences applied by the management team, is the combination of quantitative and in person research, and a focus on understanding every business that they own by meeting management on a regular basis. As we enter a period of extended volatility, we believe active management and greater diversification, rather benchmarking, will be required to deliver consistent returns.

Comments from management

The management team recently offered the following insight from the US reporting season:

"The portfolio had a strong reporting season with many of our companies continuing to deliver strong unrecognised growth (i.e. strong earnings surprise).

At the end of Q2 reporting season the portfolios average company upgrades (number of analysts upgrading vs downgrading) was at ***35.2%*** *vs only* ***18.4%*** *for the MSCI World Small Caps (date: 20 August 2020)*

- *The Trade Desk continued to deliver huge earnings surprise as connected TV and associated advertising spend continued to grow. The Trade Desk reported earnings of $0.52 vs consensus of %0.17; an earnings surprise of over 450%.*

- *Generac, a global leader in portable and small scale generators, expanding into battery cell production also had strong results as it continues to execute on its successful expansion strategy. Generac reported earnings of $1.17 vs consensus of $0.86; an earnings surprise of 64%.*

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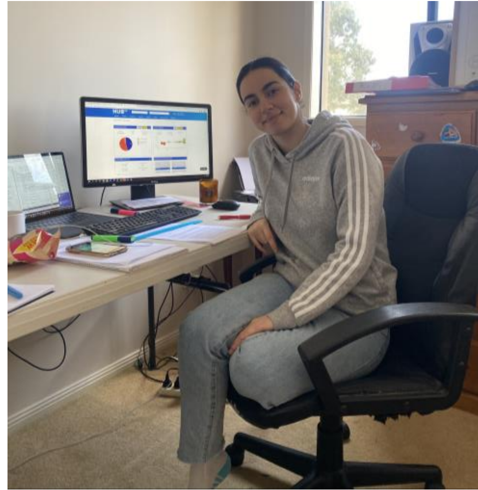
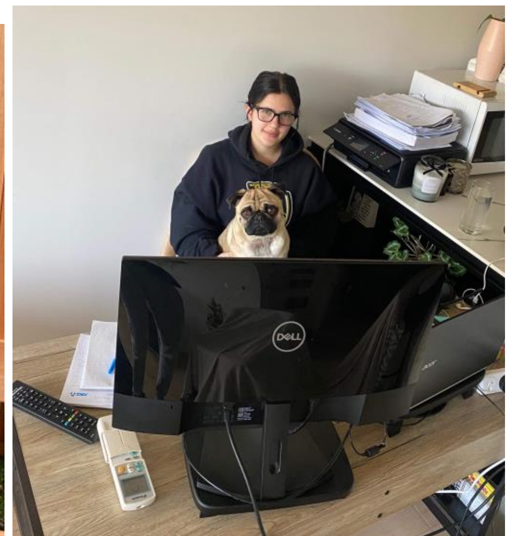
- *Capcom, our Japanese games maker saw significant strength in their key titles of Monster Hunter World and Resident Evil during the first half of the year. Combined with an increase in digital downloads and reduce costs from packaging and distribution, Capcom posted strong quarterly earnings of Y73.2 vs consensus of $40.7; an earnings surprise of 80%.*



Checking in on the Wattle Partners team

We have been inundated with calls from clients and friends across the country, checking on our Melbourne-based team. We appreciate your support and can confirm it is business as usual, albeit with a few additional team members. Below is an insight into our many 'Work from Home' set ups:



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